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Supreme Court of the United States

No. 74-176

October Term, 1974

JOSEPH W. ADKINSON, JR., et al.,
Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR A WRIT OF CERTIORARI
To the United States Court of Appeals
For the Sixth Circuit

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TABLE OF CONTENTS

Citations to Opinions Below 1

Jurisdiction 2

Questions Presented 2

United States Statutes Involved 2

Statement of the Case 5

Reasons for Granting the Writ 10

I. The question of whether a donor of a net gift realizes income is an important question of federal law of great interest to taxpayers which has not been, but should be, settled by this Court since the United States Court of Appeals for the Sixth Circuit has decided the question in a manner which is in direct conflict with decisions of the United States Court of Appeals for the Fifth Circuit and the United States Tax Court 10

II. The Circuit Court erred in holding that a taxpayer realizes income in a transaction that results in no economic gain to the taxpayer, where the taxpayer has received no previous tax benefit from the property transferred and where there has been no overall increase in the economic wealth of the taxpayer, such holding being in direct conflict with previous decisions of this Court 15

A. The lower court has misapplied the doctrine of "discharge of indebtedness" by failing to examine the total economic results of the gifts as required by a long line of decisions of this Court 17

B. The lower court has misapplied the rationale of the decision of this Court in Crane v. Commissioner in holding that Crane establishes the unwavering principle that the shedding of a debt automatically gives rise to taxable income and by failing to recognize that the taxpayer in Crane had realized an overall increase in net worth 20

Conclusion 22

Appendices:

A. Opinion of the United States Tax Court, filed March 12, 1973 ..... A1

B. Decisions of the United States Tax Court, entered March 12, 1973 ..... A43, A44, A45

C. Opinion of the United States Court of Appeals for the Sixth Circuit, filed April 9, 1974 ..... A46

D. Judgments of the United States Court of Appeals for the Sixth Circuit, entered April 9, 1974 ..... A60, A61, A62

E. Order of the United States Court of Appeals for the Sixth Circuit denying Petition for Rehearing, entered May 30, 1974 ..... A63

TABLE OF AUTHORITIES

Cases

Bowers v. Kerbaugh-Empire Co., 271 U.S. 170 (1926) 17, 18, 19
Burnet v. Campbell Co., 50 F.2d 487 (D.C. Cir. 1931) 19
Commissioner v. Jacobson, 336 U.S. 28 (1949) 19
Commissioner v. Simmons Gin Co., 43 F.2d 327 (10th Cir. 1930) 19
Commissioner of Internal Revenue v. Court Holding Co., 324 U.S. 331 (1945) 14
Crane v. Commissioner, 331 U.S. 1 (1947) 8, 10, 16, 19, 20, 21
Davis, Estate of, 30 T.C. Memo., 1971-318, *aff'd per curiam*, 469 F.2d 694 (5th Cir. 1972) 11, 13
Gregory v. Helvering, 293 U.S. 465 (1935) 14
Harrison v. Commissioner, 17 T.C. 1350 (1952) 11
Krause v. Commissioner, 56 T.C. 1242 (1971), *appeal dismissed (nol. pros.)*, (6th Cir. June 27, 1972) 11, 13
Lakeland Grocery Co., 36 B.T.A. 289 (1937) 19
Lingo v. Commissioner, 13 T.C. Memo., 1954-31 11
Meyer Jewelry Co., 3 B.T.A. 1319 (1926) 19
Old Colony Trust Co. v. Commissioner, 279 U.S. 716 (1929) 19
Turner v. Commissioner, 49 T.C. 356 (1968), *aff'd per curiam*, 410 F.2d 752 (6th Cir. 1969) 11, 12, 13, 14
United States v. Kirby Lumber Co., 284 U.S. 1 (1931) 19

Statutes and Rulings

Int. Rev. Code of 1954, §61; 26 U.S.C. §61 ..... 2, 9, 15, 16, 17
Int. Rev. Code of 1954, §1001(a), (b) and (c); 26 U.S.C. §1001(a), (b) and (c) 3

Int. Rev. Code of 1954, §1222(3); 26 U.S.C. §1222(3) 4
Int. Rev. Code of 1954, §2501(a); 26 U.S.C. §2501(a) 5
Int. Rev. Code of 1954, §2502(d); 26 U.S.C. §2502(d) 5
Rev. Rul. 71-232 1971-1 C.B. 275 .....10, 11

Articles

Eustice, *Cancellation of Indebtedness and the Federal Income Tax: A Problem of Creeping Confusion*, 14 Tax L. Rev. 225 (1959) 18, 19
Greenbaum, *Income From Debt Cancellation and Reduction*, 19 N.Y.U. Annual Institute on Federal Taxation 53 (1961) 18
Stuetzer, *Discharge of Indebtedness at a Discount*, 17 N.Y.U. Annual Institute on Federal Taxation 229 (1959) 18, 19

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PETITION FOR WRIT OF CERTIORARI
To the United States Court of Appeals
For the Sixth Circuit

To The Honorable, The Chief Justice and the Associate Justices of the Supreme Court of The United States:

Your petitioners respectfully pray that a writ of certiorari issue to review the judgments of the United States Court of Appeals for the Sixth Circuit entered April 9, 1974, a timely filed petition for rehearing having been denied May 30, 1974.

CITATIONS TO OPINIONS BELOW

The opinion of the United States Tax Court filed March 12, 1973, and published at 59 T.C. 791, and the three decisions of the Tax Court handed down against the petitioners on that same date assessing a tax deficiency against the petitioners are presented in the Appendix to this petition

at pages A1-A45. The Court of Appeals opinion of April 9, 1974, published at 495 F.2d 1079, and the judgments entered April 9, 1974, are reprinted in the Appendix to this petition at pages A46-A62. The order of the Court of Appeals denying the petition for rehearing is reprinted at page A63 of the Appendix.

JURISDICTION

The jurisdiction of this Court is invoked under the provisions of 28 U.S.C. Section 1254.

QUESTIONS PRESENTED

1. Did the Circuit Court err in holding that the donor of a net gift realizes income?

2. Does the transfer of property subject to an indebtedness result in a realization of income to the transferor when there is no overall increase in the economic wealth of the transferor?

UNITED STATES STATUTES INVOLVED

26 U.S.C. Section 61. Gross income defined.

(a) General definition.—Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items:

(1) Compensation for services, including fees, commissions, and similar items;

(2) Gross income derived from business;

(3) Gains derived from dealings in property;

(4) Interest;

(5) Rents;

(6) Royalties;

(7) Dividends;

(8) Alimony and separate maintenance payments;

(9) Annuities;

(10) Income from life insurance and endowment contracts;

(11) Pensions;

(12) Income from discharge of indebtedness;

(13) Distributive share of partnership gross income;

(14) Income in respect of a decedent; and

(15) Income from an interest in an estate or trust.

26 U.S.C. Section 1001. Determination of amount of and recognition of gain or loss.

(a) Computation of gain or loss.—The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 1011 for determining gain, and the loss shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.

(b) Amount realized.—The amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received. In determining the amount realized—

(1) there shall not be taken into account any amount received as reimbursement for real property taxes which are treated under section 164(d) as imposed on the purchaser, and

(2) there shall be taken into account amounts representing real property taxes which are treated under section 164(d) as imposed on the taxpayer if such taxes are to be paid by the purchaser.

(c) Recognition of gain or loss.—In the case of a sale or exchange of property, the extent to which the gain or loss determined under this section shall be recognized for purposes of this subtitle shall be determined under section 1002.

(d) * * *

(e) * * *

(f) * * *

26 U.S.C. Section 1222. Other terms relating to capital gains and losses.

(1) * * *

(2) * * *

(3) Long-term capital gain.—The term "long-term capital gain" means gain from the sale or exchange of a capital asset held for more than 6 months, if and to the extent such gain is taken into account in computing gross income.

(4) * * *

(5) * * *

(6) * * *

(7) * * *

(8) * * *

(9) * * *

26 U.S.C. Section 2501. Imposition of tax.

(a) Taxable transfers.—

(1) General rule.—For the first calendar quarter of calendar year 1971 and each calendar quarter thereafter a tax, computed as provided in section 2502, is hereby imposed on the transfer of property by gift during such calendar quarter by any individual, resident or nonresident.

(2) * * *

(3) * * *

(4) * * *

(b) * * *

(c) * * *

(d) * * *

26 U.S.C. Section 2502. Rate of tax.

(a) * * *

(b) * * *

(c) * * *

(d) Tax to be paid by donor.—The tax imposed by section 2501 shall be paid by the donor.

STATEMENT OF THE CASE

The three principal petitioners, Joseph W. Johnson, Jr., David F. S. Johnson and H. Clay Evans Johnson, are brothers. Early in 1965, each of them decided to make a gift of 50,000 shares of the stock of Interstate Life and Accident Insurance Company (Interstate) to his children.[1]

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1. Since the form of these transfers was substantially identical, only the gift by Dr. Johnson will be described except where peculiarities of the other two transfers are relevant.

At that time, all were active in the management of Interstate, each serving as an officer and member of the board of directors. Two of the petitioners, Joseph W. Johnson, Jr. and David Johnson, were residents of Tennessee while H. Clay Evans Johnson was a resident of Georgia.

The adjusted basis of Dr. Johnson in his 50,000 shares at the time of the gift was approximately $10,000. The fair market value of the shares was in excess of $500,000. Realizing that the transfer of these shares would create a substantial amount of gift tax liability, Dr. Johnson decided to make the gift to his children a "net gift" so as to reduce the gift tax liability on the transfer. Thus, it was determined that the gift tax should be paid out of the property to be transferred. It was then agreed that the property would be given subject to a loan equal to the estimated gift tax liability and that the proceeds of the loan would be used by Dr. Johnson to pay the state and Federal gift taxes on the transfer.

Because of a substantial blockage problem, however, the value of the shares of stock for gift tax purposes was not certain, and it was necessary to estimate the amount of gift taxes to be paid. Counsel for the petitioners estimated that the Federal and Tennessee gift taxes might amount to as much as $200,000 for the petitioners living in Tennessee. (Since H. Clay Evans Johnson was a resident of Georgia, and Georgia had no state gift tax, it was estimated that his gift tax liability might amount to as much as $175,000.)

In order to carry out his intention to make a net gift, Dr. Johnson borrowed the estimated amount of the gift taxes ($200,000) from the Hamilton National Bank of Chattanooga, Tennessee. (H. Clay Evans Johnson borrowed $175,000.) The loan was structured in such a manner that Dr. Johnson was not personally liable for the

$200,000, although the 50,000 shares of Interstate stock were pledged as collateral on the loan. Two days later, Dr. Johnson created an irrevocable trust for the benefit of his children and transferred to it all of the 50,000 shares of Interstate stock previously pledged as collateral on the loan. The trustees under this trust instrument were Dr. Johnson's wife, Margaret A. Johnson, and the bank. The trustees then assumed the $200,000 liability attached to the stock, and Dr. Johnson's account was marked "paid" by the bank. Dr. Johnson used the proceeds of the loan to purchase a $200,000 certificate of deposit from the bank, intending to use this money to pay the state and Federal gift taxes due in April of 1966.

As counsel had predicted, the initial state and Federal gift taxes assessed against Dr. Johnson equaled approximately $200,000 ($208,497.51). The total amount of gift taxes originally assessed against David F. S. Johnson and his wife was $188,352. The total Federal gift taxes (Georgia having no state gift tax) assessed against H. Clay Evans Johnson and his wife was $163,350.

After extended negotiations with both state and Federal revenue authorities, and after petitions had been filed by the petitioners in the United States Tax Court contesting the proposed gift tax deficiencies, the petitioners entered into a settlement with the revenue authorities pursuant to which Dr. Johnson paid approximately $147,000 in Federal and state gift taxes, H. Clay Evans Johnson paid approximately $125,000 and David F. S. Johnson also paid approximately $125,000. The difference between the gift taxes eventually paid by the petitioners and the amount of the loans was used by the petitioners for their own personal benefit.

On the joint Federal income tax returns which each husband and wife filed for the year 1965, no report was

made of any capital gains realized as a result of the transactions described above. In a notice of deficiency mailed to Dr. Johnson on November 21, 1968, the Commissioner of Internal Revenue determined that Dr. Johnson and his wife realized long-term capital gains on the above transaction in the amount of $189,187.50, which was the amount by which the cash received from the loans exceeded their basis in the stock transferred. This assessment was made even though a substantial portion of the cash proceeds were, in fact, used by the petitioners to pay the Federal and Tennessee gift taxes on the transfer.

The petitioners each filed a petition in the United States Tax Court seeking a redetermination of the deficiencies in income taxes as determined by the Commissioner. Pursuant to stipulation, these cases were consolidated for trial in the Tax Court.

In the Tax Court the Commissioner argued that the transfers involved were not net gifts but were, in fact, in part sales and in part gifts. He took the position that, to the extent that the property transferred was subject to a loan, the donors had sold the stock to the donees and should be deemed to have realized capital gain income in the amount by which the loan exceeded the donors' basis in the property transferred. In making this argument the Commissioner relied primarily on the case of *Crane v. Commissioner*, 331 U.S. 1 (1947).

The petitioners argued that the transfers involved were intended to be and were, in fact, gifts for the benefit of their children which were structured so that the gifts would be made net of gift taxes. The petitioners urged that gifts should not be artificially construed as "sales" where there was no intent to sell the property and distinguished *Crane* on the basis that *Crane* had involved a sale of mortgaged property.

On March 12, 1973, the Tax Court entered decisions against the petitioners and assessed deficiencies accordingly.

The petitioners appealed the Tax Court's decision to the United States Court of Appeals for the Sixth Circuit. By stipulation of the parties pursuant to Section 7482(b) of the Internal Revenue Code of 1954, it had been agreed that petitioner H. Clay Evans Johnson, a Georgia resident, would appeal to the United States Court of Appeals for the Sixth Circuit rather than to the United States Court of Appeals for the Fifth Circuit. All parties stipulated that the appeals of all of the petitioners would be consolidated since they involved an identical issue for decision, pursuant to Rule 3(b) of the Federal Rules of Appellate Procedure.

On appeal, the petitioners conceded that they had realized a capital gain on the amount by which the excess loan proceeds exceeded their basis in the property under the reasoning of *Crane* but further argued that *Crane* did not apply where the transfer of property subject to a mortgage results in no tax benefit or economic gain to the transferor and, thus, should not apply to the loan proceeds used to pay the gift taxes on the transfer.

The Sixth Circuit affirmed the Tax Court in a decision based, however, on a substantially different analysis of the question than that of the Tax Court and also with a different emphasis from that of the Commissioner. The Sixth Circuit stated in its opinion that it made no difference whether the transfers were deemed to be "net gifts" or in part sales and in part gifts. The court held that regardless of the label put on the transfer the petitioners realized income under Section 61 of the Internal Revenue Code and expressly applied the concept of discharge of indebtedness under Section 61(a)(12). The court, al-

ternatively, ruled that the holding of *Crane v. Commissioner*, 331 U.S. 1 (1947), was applicable to the transfers even if they were deemed to be net gifts.

REASONS FOR GRANTING WRIT

I. The question of whether a donor of a net gift realizes income is an important question of federal law of great interest to taxpayers which has not been, but should be, settled by this Court since the United States Court of Appeals for the Sixth Circuit has decided the question in a manner which is in direct conflict with decisions of the United States Court of Appeals for the Fifth Circuit and the United States Tax Court.

A net gift is a transfer in which the value of the gift, for gift tax purposes, is reduced by the amount of the gift taxes paid. This result is accepted by the Commissioner and occurs when the donor shifts the economic burden of the gift tax to the donee either by ensuring that the gift tax is paid out of the property transferred by subjecting the property to a liability equal to the gift tax prior to the transfer or by conditioning the gift on the donee's agreement to pay the gift tax. *Rev. Rul.* 71-232 1971-1 C.B. 275. In either case, the economic realities of the transfer are identical. The donee's overall economic wealth is not increased as much as it would have been had the donor borne the burden of the gift tax. The net reduction in the donor's wealth, however, is the same regardless of whether the donor reduces the amount given by paying the gift tax prior to the transfer or requires the donee to pay the gift tax as a condition of the gift.

For example, if X desires to give property valued at $20,000 to Y, he can reduce the amount of the gift taxes

paid on such transfer by requiring Y to pay the gift tax of $1,600 on the transfer. This requirement reduces the amount of the gift for gift tax purposes to $18,400 and requires a recomputation of the gift tax due.[2] *See Harrison v. Commissioner*, 17 T.C. 1350 (1952); *Lingo v. Commissioner*, 13 T.C. Memo., 1954-31. An identical result occurs if X reserves the amount necessary to pay the gift tax out of the property given and transfers only the balance to Y.

Until the decision of the United States Court of Appeals for the Sixth Circuit in the case at bar, it was also well settled that the making of a net gift did not result in the realization of income to the donor. *Estate of Davis*, 30 T.C. Memo., 1971-318, *aff'd per curiam*, 469 F.2d 694 (5th Cir. 1972); *Victor W. Krause*, 56 T.C. 1242 (1971), *appeal dismissed (nol. pros.)*, (6th Cir. June 27, 1972); *Turner v. Commissioner*, 49 T.C. 356 (1968), *aff'd per curiam*, 410 F.2d 752 (6th Cir. 1969).

The petitioners submit that in its opinion affirming the Tax Court the Sixth Circuit has effectively overruled its decision in *Turner v. Commissioner* and determined the question of whether a donor realizes income upon payment of the gift tax by a donee in a manner that is in direct conflict with the holdings of each of the above cases. The United States Court of Appeals for the Fifth Circuit and the United States Tax Court have not overruled their determinations of this issue.

In *Turner*, the taxpayer had made a gift of certain shares of highly appreciated stock on the condition that the recipients, several trusts and three individual donees, pay the resulting gift tax liability. With regard to the

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2. The ultimate gift tax liability is determined on the basis of an algebraic formula set forth in *Rev. Rul.* 71-232, *supra*.

gifts in trust, the respective trustees agreed to pay all gift taxes as trustees without personal liability. The trustees paid a substantial portion of these gift taxes by selling some of the shares transferred to the trust and by obtaining loans from the donor's mother. In fact, however, the donees did not pay the gift taxes directly to the Commissioner but merely reimbursed the donor the amount equal to the gift taxes.

In *Turner*, the Commissioner first took the position that the transfer of stock was in part a sale and in part a gift as to both the individual donees and the trusts. Thus, he argued that to the extent the gift taxes paid exceeded the donor's basis in the stock transferred, the donor had realized taxable income. On brief, however, he conceded that the transfers to the trusts were simply net gifts and resulted in no taxable income being realized by the donor. He did strongly argue, however, that the payment of the gift tax by the individual donee resulted in the donor realizing income. The Sixth Circuit posed the question in the following manner:

> [t]his case involved the question whether a taxpayer, who transferred shares of stock to her children and to trustees of her grandchildren upon the agreement by the children to reimburse her for the gift tax and the agreement by the trustees to make reimbursement out of the corpora of the trusts, realized taxable income on the amounts paid to her pursuant to said agreements. 410 F.2d at 753.

The Sixth Circuit held that a donor does not realize income when the donee reimburses him for the amount of the gift taxes due on the transfer.

The United States Court of Appeals for the Fifth Circuit and the United States Tax Court have expressly re-

lied on *Turner* and have interpreted *Turner* as standing for the proposition that a donor does not realize income when a donee bears the burden of paying the gift tax. *Estate of Davis, supra; Victor W. Krause, supra.* The fact situations in these two cases were almost identical to *Turner.* In *Davis,* the taxpayer had transferred appreciated stock to two irrevocable trusts for the benefit of his two children and to a third child as an individual. The stock had a total fair market value of 1.4 million dollars, and the taxpayer had a basis in the stock of around $13,000. The gifts were net gifts, being made on the condition that the donees pay the gift taxes on the transfer. Although the Commissioner argued that the donor should realize income to the extent the gift taxes paid exceeded the donor's basis, the Fifth Circuit, expressly relying on the holding of *Turner,* ruled that income was not realized upon such transfer.

In *Victor W. Krause,* the taxpayer also transferred appreciated property to three trusts created for the benefit of his grandchildren and required the trustees to pay the resulting gift tax liability. The Tax Court, also following *Turner,* rejected the argument that a donor realizes income upon such a transfer.

The petitioners recognize that there are certain factual differences between the case at bar and these previous net gift cases. In the earlier cases the donors made gifts and required the donees to pay the gift taxes. In fact, however, the donees simply reimbursed the donor an amount equal to the gift taxes paid by the donor. In the case at bar, the donee subjected the property to an indebtedness and transferred the property subject to that indebtedness. The donor then used a substantial portion of the indebtedness to pay the gift taxes on the transfer. The economic realities of the transfers are identical, however,

and in determining whether income is realized substance should control over form. *Gregory v. Helvering*, 293 U.S. 465, 470 (1935); *Commissioner of Internal Revenue v. Court Holding Co.*, 324 U.S. 331, 334 (1945). In each case the donee's overall economic wealth is not increased as much as it would have been had the donor borne the burden of the gift tax. In each case, the net reduction of the donor's wealth is the same. In fact, the United States Court of Appeals for the Sixth Circuit in the case at bar has held that, to the extent the loan proceeds were used to pay the gift taxes on the transfers, the taxable consequences are indistinguishable from the situation where the transfer is made subject to the condition that the donee pay the gift tax. 495 F.2d at 1082.

Therefore, the decision in the case at bar is in direct conflict with an earlier decision of the same Circuit Court in *Turner* and the decisions of the Court of Appeals for the Fifth Circuit and the Tax Court relying on *Turner*.

This Court has never faced the question of whether the donor of a net gift realizes income. In view of the importance of this question and the conflict that now exists among the Circuits and the Tax Court, the petitioners respectfully submit that their petition for writ of certiorari be granted.

II. The Circuit Court erred in holding that a taxpayer realizes income in a transaction that results in no economic gain to the taxpayer, where the taxpayer has received no previous tax benefit from the property transferred and where there has been no overall increase in the economic wealth of the taxpayer, such holding being in direct conflict with previous decisions of this Court.

The Circuit Court's determination that the petitioners realized income from the transfers in question was based upon the reasoning that the petitioners had received "something of value" upon transferring their encumbered stock into trust and that the receipt of "something of value" was income under the broad definition in Section 61 of the Internal Revenue Code of 1954[3] which governs "all income from whatever source derived."

> The fact is that each taxpayer received *something of value* upon transferring his encumbered stock into trust. 495 F.2d at 1083 (Emphasis added).

The court refused to examine the economic consequences of the entire transaction and disregarded the fact that a substantial portion of the loan proceeds—"something of value"—was used by the petitioners to pay the gift taxes on the transfer. The court specifically stated:

> [i]t makes no difference to what use the $200,000 was put, whether to pay for food or to pay a gift tax. 495 F.2d at 1083.

The court went on to hold that income was realized under two tax concepts: (1) the discharge of an indebted-

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3. All references to the Internal Revenue Code of 1954 will be abbreviated "the Code" in the remainder of this petition.

ness under Section 61(a)(12) of the Code and (2) the rationale of *Crane v. Commissioner*, 331 U.S. 1 (1947).

The petitioners respectfully submit that the Circuit Court misapplied each of these concepts. It failed to recognize that this Court has held, in a long line of cases, that in determining whether income is realized by a taxpayer a court must examine the total economic results of the transaction to determine whether there has been any economic gain to the taxpayer, either by taking advantage of some tax benefit (past or present) or through some overall increase in economic wealth. This analysis is clearly reflected in the well-established principle that income is not realized when property is subjected to a mortgage or loan. Even though the taxpayer in such a situation receives "something of value", no realization of income occurs because the loan proceeds equal the amount of the debt, assets and liabilities increase equally, there is no increase in the taxpayer's net worth. In failing to take into consideration the fact that there is no economic gain to the donor of a net gift, the Circuit Court erroneously held that income is realized upon the payment of the gift tax by the donee.

In the case at bar, the petitioners have divested themselves of a substantial amount of property. While it is true that by making this divestment in the form of a net gift they have reduced their gift tax liabilities, they have in no way increased their overall economic wealth or received any tax benefit themselves. The donor of a net gift gives up the same amount of property regardless of whether he sells the property and transfers the after-tax dollars to the donee or transfers the property to the donee on the condition that the donee pay the gift tax. Either way, it is the donee who receives less as a result of the net gift rather than the donor who realizes any economic gain.

A. The lower court has misapplied the doctrine of "discharge of indebtedness" by failing to examine the total economic results of the gifts as required by a long line of decisions of this Court.

This Court has ruled that if upon examination of the entire transaction the discharge of indebtedness does not result in any economic benefit to or increase in the overall net worth of the debtor, the debtor does not realize income under Section 61 of the Code. *Bowers v. Kerbaugh-Empire Co.*, 271 U.S. 170 (1926).

In *Kerbaugh-Empire Co.*, the taxpayer borrowed German marks from a German bank to finance the unsuccessful operation of a German subsidiary. Subsequently, the loan was repaid in devalued German marks at approximately one-seventh of the original value in dollars. By repaying in devalued German marks, the taxpayer realized a substantial balance sheet improvement but, despite this saving, suffered an overall economic loss on the transaction since the German marks borrowed had been invested in a business venture in Germany which proved to be unsuccessful.

The Commissioner argued that this Court should not look beyond the taxpayer's balance sheet improvement in order to determine whether the taxpayer had realized income under what is now Section 61 of the Code. This argument is identical to the position taken by the lower court in this case, namely, that the overall economic effect on the taxpayer's net worth need not be considered for purposes of determining whether income is realized under Section 61.

This Court flatly rejected the Commissioner's contention after examining the overall economic effect of the transaction and concluding that the reduction of debt

under such circumstances did not give rise to income within the contemplation of the income tax statutes. In *Kerbaugh-Empire Co.*, this Court stated that:

> [t]he contention that the item in question is cash gain disregards the fact that the borrowed money was lost. . . . The loss was less than it would have been if marks had not declined in value; but the mere diminution of loss is not gain, profit, or income. 271 U.S. at 175.

The petitioners respectfully submit that the Circuit Court erred in failing to recognize that the taxpayer's total economic situation must be considered under the "discharge of indebtedness" concept and that such consideration requires an examination of the overall economic consequences of the whole transaction. See also Eustice, *Cancellation of Indebtedness and the Federal Income Tax: A Problem of Creeping Confusion*, 14 Tax L. Rev. 225, 243 (1959); Greenbaum, *Income from Debt Cancellation and Reduction*, 19 N.Y.U. Annual Institute on Federal Taxation 53, 64 (1961); Stuetzer, *Discharge of Indebtedness at a Discount*, 17 N.Y.U. Annual Institute on Federal Taxation 229, 240 (1959). This is particularly true when the indebtedness and the discharge of such indebtedness have arisen out of the same transaction; a transaction which results in an overall reduction in each taxpayer's net worth. Had the lower court considered the total economic effect of the transaction in the case at bar, it would have found that, to the extent the loan proceeds were used to pay the petitioners' gift taxes, the petitioners did not realize any economic benefit or increase in overall economic net worth. All that the petitioners managed to do was to reduce the amount of assets passing from them as a result of the gifts and minimize the overall reduction in wealth. Such diminution of loss is not gain, profit or income.

The rationale of *Kerbaugh-Empire Co.*, requiring an overall economic gain for income to be realized, has been consistently adhered to by this Court in later cases dealing with realization of income "from whatever source derived." *Commissioner v. Jacobson*, 336 U.S. 28 (1949); *Crane v. Commissioner*, 331 U.S. 1 (1947); *United States v. Kirby Lumber Co.*, 284 U.S. 1 (1931); *Old Colony Trust Co. v. Commissioner*, 279 U.S. 716 (1929). In *Kirby Lumber Co.* for example, although this Court held that a corporation's purchase of its own bonds for less than par value resulted in income being realized by the corporation, Justice Holmes was careful to distinguish *Kerbaugh-Empire Co.*, recognizing that in the latter case the transaction "as a whole was a loss. . . . Here there was no shrinkage of assets and the taxpayer made a clear gain." 284 U.S. at 3.

An analogous line of cases which has also required an overall increase in the net worth of the debtor before discharge of the debt produces income is the "insolvent debtor" cases. See, *Lakeland Grocery Co.*, 36 B.T.A. 289 (1937); *Burnet v. Campbell Co.*, 50 F.2d 487 (D.C. Cir. 1931); *Commissioner v. Simmons Gin Co.*, 43 F.2d 327 (10th Cir. 1930); *Meyer Jewelry Co.*, 3 B.T.A. 1319 (1926). These cases reasoned that when a debtor is insolvent, the cancellation of his debt frees no assets and hence results in no income. This exception is consistent with the *Kerbaugh-Empire Co.* and *Kirby Lumber Co.* analysis. *See* Eustice, *Cancellation of Indebtedness and the Federal Income Tax: A Problem of Creeping Confusion*, *supra* at 246; Steutzer, *Discharge of Indebtedness at a Discount*, *supra* at 233.

B. The lower court has misapplied the rationale of the decision of this Court in Crane v. Commissioner in holding that Crane establishes the unwavering principle that the shedding of a debt automatically gives rise to taxable income and by failing to recognize that the taxpayer in Crane had realized an overall increase in net worth.

As discussed in Argument I of this petition, the net gift results in the economic burden of the gift tax being shifted from the donor to the donee. This result occurs when the donor conditions the gift on the donee's paying the gift tax but can also occur by the donor's attaching a liability to the property transferred equal to the gift tax and using the proceeds from such liability to pay the gift tax on the transfer. In each case, the donor realizes no economic gain or increase in overall net worth from the transfer. In each case the donee receives the same amount.

The alternative holding of the lower court in this case was that, although two transactions described above are substantively identical, the rationale of *Crane v. Commissioner, supra,* applies to the situation in which property subject to a loan is transferred to a donee even though the proceeds of the loan are used to pay the gift tax on the transfer, but does not apply where the donor conditions the gift on the donee's agreement to pay the gift tax. Petitioners respectfully submit that there is no rational basis for such a distinction and that *Crane v. Commissioner* does not establish the principle that the shedding of a debt, perforce, gives rise to taxable income. Rather, *Crane* is a further recognition of the doctrine espoused in other Section 61 cases that income is realized only to the

extent an overall increase in wealth or some economic benefit results from the transfer of mortgaged property.

In *Crane,* the taxpayer had inherited an apartment building and lot subject to a mortgage of $255,000 and interest in default of $7,042.50. The property had been appraised for federal estate tax purposes at a value exactly equal to the total amount of this encumbrance. During the time in which she owned the property the petitioner deducted $28,045.10 as depreciation on the building, using the amount of the mortgage as the cost basis of the property. The taxpayer later sold the lot and building for a small amount of cash and reported a taxable gain only to the extent of the cash received. She argued that she had acquired only an equity interest in the property, represented by the excess in the value of the building and lot over the amount of the mortgage, which had a zero value. Since she had never personally assumed the mortgage, she argued that the amount realized on the sale was only the amount of cash received.

This Court held for the Commissioner, reversing the Tax Court, and ruled that the taxpayer should be taxed to the extent of the benefits which she had received from the depreciation deductions which she took while she owned the property. The Court did not hold that the taxpayer realized income on the entire amount of the indebtedness assumed by the buyer, but only taxed the taxpayer on that portion which represented an economic gain to her. The gain was measured by the tax benefit she had earlier received from being able to take depreciation deductions on a basis which included the mortgage on the property. This tax benefit resulted in an overall increase in the net worth of the taxpayer, and she was deemed to have realized income to that extent.

In the case at bar there has been no economic gain or any increase in net worth as a result of the making of these gifts. The transfer of property subject to an indebtedness under these circumstances does not give rise to taxable income.

CONCLUSION

For all the foregoing reasons, the petition for writ of certiorari should be granted.

Respectfully submitted,

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APPENDIX

OPINION OF THE UNITED STATES TAX COURT

(Filed March 12, 1973)

Docket Nos. 5602-69, 5638-69, 5639-69

UNITED STATES TAX COURT

WASHINGTON

JOSEPH W. JOHNSON, JR. and
MARGARET A. JOHNSON, *et al.*,[1]
Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

BRUCE, Judge:

Respondent determined deficiencies in the income taxes of the petitioners for the taxable years and in amounts as follows:

Docket Number	Petitioner	Taxable Year	Deficiency
5602-69	Johnson, Joseph W., Jr. and Margaret A.	1965	$47,660.02
5638-69	Johnson, H. Clay Evans and Betty Mead	1965	$42,774.26
		1966	9,440.64
5639-69	Johnson, David F. S. and Elise E.	1965	$50,832.04

1. Proceedings of the following petitioners are consolidated herewith: H. Clay Evans Johnson and Betty Mead Johnson, Docket No. 5638-69; David F. S. Johnson and Elise E. Johnson, Docket No. 5639-69.

Certain adjustments contained in the statutory notices of deficiency have been conceded by the respective petitioners.

The principal issue, common to each of the cases, is whether the respective petitioners realized taxable income in 1965 upon the transfer of 50,000 shares of stock, having a basis of $10,812.50 and a fair market value of $500,000, to a trust for the benefit of their children, where such stock had been pledged as collateral security for bank loans, obtained one or two days prior to such transfer, in the amount of $200,000 (in two of the cases) and $175,000 (in the other case), the notes evidencing the loans were endorsed "without personal liability," the trustees assumed payment of the loans by substituting their notes for those of the petitioners which were then stamped as paid, and the petitioners used the proceeds of the loans for their own personal purposes.

A second issue in the case of H. Clay Evans Johnson and Betty Mead Johnson is whether the petitioners therein are entitled to deduct as losses in 1965 and 1966 the cost of maintaining and operating a residence in Sea Island, Georgia, in excess of rentals received.

Findings of Fact

Joseph W. Johnson, Jr., David F. S. Johnson and H. Clay Evans Johnson are brothers. During the years in issue, all three were active in the management of Interstate Life and Accident Insurance Company (Interstate), located in Chattanooga, Tennessee, serving as officers and members of the board of directors. H. Clay Evans Johnson was president, Joseph W. Johnson, Jr. was vice president and medical director, and David F. S. Johnson was executive vice president. Joseph W. Johnson, Jr. and his wife, Margaret A. Johnson, filed a joint Federal income tax return

for the calendar year 1965 with the district director of internal revenue, Nashville, Tennessee. David F. S. Johnson and his wife, Elise E. Johnson, filed a joint Federal income tax return for the calendar year 1965 with the district director of internal revenue, Nashville, Tennessee. H. Clay Evans Johnson and his wife, Betty Mead Johnson, filed joint Federal income tax returns for the calendar years 1965 and 1966 with the district director of internal revenue, Atlanta, Georgia. At the time the petitions herein were filed, H. Clay Evans Johnson and Betty Mead Johnson resided in Dade County, Georgia, and the other petitioners resided in Hamilton County, Tennessee.

On March 9, 1965, Dr. Joseph W. Johnson, Jr., borrowed $200,000 from the Hamilton National Bank in Chattanooga, Tennessee. As security for such loan, Dr. Johnson signed a 30-day note dated March 9, 1965, in the amount of $200,000. On the note immediately after the signature of Dr. Johnson the words "without personal liability" were written. Such note also provided that 50,000 shares of Interstate stock were being pledged as collateral security for payment of the note.

At the same time the $200,000 note was signed, Dr. Johnson delivered to the bank as collateral security for such note two stock certificates, Nos. A-1044 and A-1046, representing 50,000 shares of Interstate stock. The two certificates were endorsed by Dr. Johnson and the space provided for the designation of the person who was entitled to have such stock transferred on Interstate's books was left blank.

On March 9, 1965, the bank established a "Direct Liability" account for Joseph W. Johnson, Jr. and made a debit to such account in the amount of $200,750. This amount represented the principal amount of the loan for $200,000 plus interest of $750 for 30 days.

On March 11, 1965, Joseph W. Johnson, Jr. created an irrevocable trust for the benefit of his children and transferred to it, as the corpus of the trust, all his right, title and interest in the 50,000 shares of Interstate stock pledged to the bank as collateral security for the payment of the note of March 9. The trustees under the trust instrument were Dr. Joseph W. Johnson's wife, Margaret Austin Johnson, and the bank.

The trust agreement provided, in part:

ARTICLE 6

DISTRIBUTION OF INCOME AND CORPUS

6-a. *Distribution of Income.* So much of the share of the Income of the Fund as shall be apportioned to a separate trust that is continued in trust for the benefit of a child or other descendant of Joseph W. Johnson, Jr., of David F. S. Johnson or of H. Clay Evans Johnson, as the trustees (in their sole discretion) shall deem necessary or advisable, and in the best interests of the beneficiary, shall be distributed to or used for the benefit of the beneficiary or of the then living children of such beneficiary at such times and in such amounts as the trustees shall determine.

6-b. *Treatment of Accumulated Income.* Any income not distributed or used as above provided shall be invested by the trustees to the extent they shall deem advisable, and such accumulated income shall, at the election of the trustees, either continue to constitute income of the trust from which discretionary distribution of income may be made by the trustees, or may be transferred to corpus for handling and distribution as such.

6-c. *Distribution of Corpus.* The trustees may encroach upon the corpus of any trust hereunder, if deemed advisable for the proper support, maintenance or education of any income beneficiary thereof. Any such encroachment shall be considered an advancement and shall be charged, without interest, against such beneficiary upon any subsequent apportionment or against those beneficiaries taking such beneficiary's share of such trust.

* * * * *

ARTICLE 7

GENERAL POWERS, DUTIES AND OBLIGATIONS OF TRUSTEES AND MISCELLANEOUS PROVISIONS

7-a. *General Discretionary Powers.* The trustees shall, except as herein otherwise expressly provided, be fully empowered to lend money at interest and to receive, hold, control, manage, collect, rent, lease, sell, exchange, transfer, convey, invest and reinvest, any and every item of money and other property owned by any trust. In making any investments or reinvestments, the trustees shall not be restricted to those authorized or prescribed by any present or future law governing trust investments in the State of Tennessee or any other State.

7-b. *Specific Discretionary Powers.* In addition to the powers of the trustees under *Paragraph 7-a*, the trustees shall have the following specific discretionary powers, duties and obligations:

(1) *Diversification.* To acquire, receive and retain investments for any trust, without regard to prin-

ciples of diversification, and without regard to the predominance of common stocks (or stocks in close corporations) in the trust. The trustees are specifically authorized to retain in the trusts any stock in Interstate Life & Accident Insurance Company of Chattanooga, Tennessee.

* * * * *

(9) *Borrowing by Trustees.* To borrow money from the commercial department of any corporate trustee serving hereunder and/or from any other source, with or without the pledge of assets of the trust estate, upon such terms and conditions as they may deem advisable.

* * * * *

7-k. *Distributable Income.* Out of the annual gross income of the trust estate the trustees shall first pay all lawful taxes and all expenses properly incident to administering the trust, including the compensation to themselves as trustees as above authorized (provided that all income taxes and other taxes imposed on account of capital gains or other capital transactions hereunder shall be paid from and charged to corpus). The remainder after all proper charges thereto shall constitute the income to be expended and disposed of as hereinbefore directed.

* * * * *

During the months of March, April and May of 1965, the fair market value of the 50,000 shares delivered by Dr. Joseph Johnson to the Hamilton National Bank was in excess of $500,000. The adjusted basis of Dr. Johnson in such 50,000 shares during the taxable year 1965 was $10,812.50.

On March 11, 1965, stock certificates Nos. A-1044 and A-1046 held by the bank were sent to the Transfer Department of Interstate so that the ownership of such certificates could be transferred to the irrevocable trust established by Dr. Johnson.

On March 12, 1965, stock certificates Nos. A-1044 and A-1046 were canceled on the books of Interstate and new certificates were issued in the name of "Hamnat & Company," a nominee of the bank used for the purpose of holding legal title to stock held by the bank as trustee. The effect of this transfer was to place ownership of the stock in the trust established by Joseph W. Johnson, Jr. The new certificates were then returned to the bank, which continued to hold them as collateral security for payment of the note of March 9.

On April 8, 1965, Margaret A. Johnson and a representative of the Hamilton National Bank, acting as co-trustees under the provisions of the Joseph W. Johnson trust, executed two notes payable to the Hamilton National Bank. One note was a 90-day note in the amount of $200,000 representing the principal of the $200,000 note signed by Dr. Johnson on March 9. As collateral security for the payment of this note, the trustees pledged the 50,000 shares of Interstate stock, the ownership of which was transferred to the trust on March 12, 1965. The second note, due June 16, 1965, was in the amount of $750 representing the interest on the $200,000 note signed by Dr. Johnson on March 9.

After the two notes of April 8, 1965, were executed by the trustees of the Joseph W. Johnson trust, the Hamilton National Bank, on May 4, 1965, stamped the $200,000 note of March 9 "Paid" and on May 6, 1965, credited the "Direct Liability" account of Dr. Johnson for a total of $200,750, thus leaving a zero balance in his account.

On May 6, 1965, a "Direct Liability" account was set up by the bank for the trustees of the irrevocable trust of Joseph W. Johnson. A debit was made thereto on May 6, 1965, for the principal sum of $200,000 plus interest.

None of the shares of Interstate stock held by the trustees were sold until January 1967, at which time 2,000 shares were sold for $27,000. In July 1967, another 2,000 shares were sold for $30,000. In September 1967, $50,000 was applied against the note.

On April 15, 1966, Joseph W. Johnson, Jr. and Margaret Austin Johnson each filed a gift tax return electing therein to have the transfers made by both parties to third parties during the calendar year 1965 considered as having been made one-half by each of them. On such returns, the transfer of the 50,000 shares of Interstate stock to the Joseph W. Johnson trust was reported. On the returns a value was assigned to such shares as of March 11, 1965. From this value was subtracted the principal indebtedness of $200,000 outstanding against such shares as of March 11, 1965. A gift tax was paid on the remaining value, i.e., the reported value of the shares less the outstanding indebtedness of $200,000. The amount of tax shown to be due on, and paid with, these returns with respect to this gift was $43,641.15 and $43,097.18, respectively.

Statutory notices of deficiency of gift tax were mailed to Joseph W. Johnson, Jr., and Margaret A. Johnson on August 13, 1969, in which notices the amounts of the proposed deficiencies were $38,536.82 and $38,539.65, respectively.

On November 8, 1969, Joseph W. Johnson, Jr., and Margaret A. Johnson filed petitions with this Court contesting the amount of deficiency shown in the statutory notices

referred to in the preceding paragraph, and on November 30, 1970, decision documents were filed by the parties with this Court in Docket Nos. 5601-69 and 5603-69 under which the parties have agreed to the assessment of additional gift taxes for the year 1965 in the amounts of $19,636.82 and $19,639.65, respectively.

On April 15, 1966, Dr. Joseph W. Johnson filed a State of Tennessee gift tax return. On such return, the transfer of the 50,000 shares of Interstate stock to the Joseph W. Johnson trust was reported with a value assigned to such shares as of March 11, 1965. From this value was subtracted the principal indebtedness of $200,000 outstanding against such shares as of March 11, 1965. A gift tax was paid on the remaining value, i.e., the reported value of the shares less the outstanding indebtedness of $200,000. The amount of tax shown to be due on, and paid with, these returns with respect to this gift was $16,514.47.

On September 15, 1966, the Department of Revenue of the State of Tennessee issued a notice of assessment of additional gift taxes against Joseph W. Johnson, Jr., for the calendar year 1965 in the amount of $28,168.24, based on an increased value for the Interstate stock, which assessment was not paid.

On December 31, 1966, Joseph W. Johnson, Jr., paid additional Tennessee gift taxes for the calendar year 1965 in the amount of $4,543.24 as a result of a settlement reached with the Tennessee Department of Revenue, which settlement reflected an increased valuation placed on the Interstate stock by the Tennessee Department of Revenue.

David F. S. Johnson and H. Clay Evans Johnson each engaged in a series of transactions substantially similar to those engaged in by Joseph W. Johnson, Jr. David

borrowed $200,000 from the Hamilton National Bank on March 9, 1965. Clay borrowed $150,000 on March 9th and an additional $25,000 on March 10, 1965. Each executed 30-day notes endorsed "without personal liability" and pledged 50,000 shares of Interstate stock as collateral security. The fair market value of the stock was $500,000 and the basis of each was $10,812.50. On March 11, 1965, each created an irrevocable trust for the benefit of his children, to which he transferred all his interest in the 50,000 shares of Interstate stock pledged as security for his loans and named his wife and the bank as trustees. The trust agreements were substantially similar to the one executed by Dr. Joseph Johnson. On March 12, 1965, the stock certificates delivered to the bank on March 9th by David and Clay were cancelled and new certificates for 50,000 shares each were issued in the name of "Hamnat & Company," a nominee of the bank, and thereafter held by the bank as collateral security for their loans. On April 28, 1965, the co-trustees of each of the trusts executed their notes to the bank in the amounts of $200,000 and $175,000, respectively, which were used to replace the notes of the trustors, and the trustors' notes were stamped by the bank as "Paid." The co-trustees of each of the trusts also executed notes to the bank in the amounts of $750 and $650, respectively, representing the interest for 30 days which the bank had debited to the "Direct Liability" accounts established for David and Clay. The Interstate stock which had been transferred to each of the trusts was pledged as collateral security for the trustees' notes. On May 6, 1965, "Direct Liability" accounts were established for the trustees and debits made thereto for the principal sums ($200,000 and $175,000, respectively) plus interest. On the same date, credits were made to the "Direct Liability" accounts of David and Clay in the

amounts of $200,750 and $175,650, respectively, thus leaving zero balances in each of said accounts.

In January 1967, 2,000 shares of the stock held by the trustees of the David F. S. Johnson trust were sold for $27,000 and, in October 1967, $19,275.08 was applied against their note. Also, in January 1967, 2,000 shares of the stock held by the trustees of the H. Clay Evans Johnson trust were sold for $27,000 and, in October 1967, $20,424.21 was applied against their note.

On April 15, 1966, David Johnson and his wife, Elise Johnson, filed separate gift tax returns in which they elected to have the transfers made by them in 1965 considered as having been made one-half by each of them. Separate gift tax returns were also filed by Clay Johnson and his wife, Betty Mead Johnson, on April 15, 1966, in which similar elections were made. On such returns the transfer of 50,000 shares of Interstate stock to the respective trusts was reported and a value assigned to such stock as of March 11, 1965. From this value the amount of the loan for which such stock was pledged as security was subtracted and a gift tax paid on the remainder. David and Elise Johnson each reported and paid a gift tax in the amount of $28,462.50. Clay and Betty Mead Johnson each reported and paid a gift tax in the amount of $35,212.50. On August 13, 1969, statutory notices of deficiencies were mailed to each of the above petitioners wherein deficiencies were determined in the amount of $43,012.50 each as to David and Elise Johnson and $46,462.50 each as to Clay and Betty Mead Johnson. Each of the petitioners filed petitions with this Court on November 8, 1969, contesting the deficiencies shown in such notices, and on November 30, 1970, decision documents were filed with this Court under which David and Elise Johnson each agreed to the assessment of additional gift

taxes for the year 1965 in the amount of $24,112.50, and Clay and Betty Mead Johnson each agreed to the assessment of additional gift taxes for 1965 in the amount of $27,562.50.

On April 15, 1966, David Johnson also filed a State of Tennessee gift tax return on which he reported the transfer of the 50,000 shares of Interstate stock to the David Johnson trust and assigned a value thereto as of March 11, 1965. From such value he subtracted the $200,000 loan and paid a gift tax on the remainder, in the amount of $13,770.00. On September 15, 1966, the Department of Revenue of the State of Tennessee issued a Notice of Assessment of Additional Gift taxes against David Johnson for 1965 in the amount of $31,625.00. This assessment was not paid. In 1966, as the result of a settlement reached with the Tennessee Department of Revenue, David Johnson paid additional Tennessee gift taxes for 1965 in the amount of $6,250.00. The state of Georgia, where H. Clay Evans Johnson and his wife reside, imposes no gift tax.

The total actual gift tax liability paid by each husband and wife couple is computed in the following table. This actual liability is the sum of all United States and state gift taxes paid when the petitioners' gift tax returns were filed and at a later date after settlement of the proposed deficiencies:

	Joseph & Margaret	Clay & Betty	David & Elise
itial U. S. Gift Taxes	$ 86,738.33	$ 70,425.00	$ 56,925.00
ditional U. S. Gift Taxes	39,276.47	55,125.00	48,225.00
itial Tennessee Gift Taxes	16,514.47	(No State Gift Tax imposed)	13,777.00
ditional Tennessee Gift Taxes	4,543.24	(No State Gift Tax imposed)	6,250.00
otal Gift Taxes Paid	$147,072.51	$125,550.00	$125,177.00

On the Federal income tax returns which each husband and wife couple filed for the taxable year 1965, no report was made of any capital gains realized as the result of the transactions related above. In the statutory notices of deficiency mailed to each couple on August 13, 1969, the respondent determined that each husband and wife couple realized long-term capital gains on the above transactions to the extent that the cash received from the loans exceeded their basis in the stock transferred.

On or about August 1, 1961, the petitioners H. Clay Evans Johnson and his wife, Betty Mead Johnson, purchased a house and lot located on Sea Island, Georgia, at a cost of $39,000. For purposes of depreciation, on their income tax returns for the years prior to 1965, petitioners reported the value of the house as being $35,500.

The house consisted of a front entrance hall, living room, screened porch, dining room, pantry and kitchen on the first floor, and three bedrooms and two baths on the second floor. There was also a two-car garage with a two-bedroom apartment above the garage. The house was fully furnished and each room, as well as the garage apartment, had a window air-conditioning unit.

The petitioners had three children—two girls and a boy, who were 18, 14 and 10 years of age at the time the house was purchased in 1961. In addition to their principal residence on "The Mountain" in Chattanooga, petitioners owned stocks, bonds and other real estate, from which they have received substantial income. Their returns for the years in issue disclosed income from salaries, dividends, taxable interest, net capital gains, tax-exempt interest, and rental income as follows:

	1965	1966
Salaries	$46,350.00	$52,966.64
Dividends	56,031.59	67,304.90
Taxable Interest	358.25	7,902.83
Capital Gains	3,213.75	332.81
Tax-Exempt Interest	2,323.75	2,323.74
Chattanooga Rental Prop.	884.02	1,464.88

Sea Island is an island off the coast of Georgia which is approximately five mlies long and one mile wide. The island is a resort area attractive to vacationers. The Sea Island Company owns and operates a hotel on the island known as "The Cloister." There are also a number of privately owned cottages on the island, some of which are made available for rental to vacationers. The Sea Island Company acts as agent for the owners in arranging for the rental of such cottages, for which services the Cottage Rental Department of the company charges a commission of 15 percent of the rental.

Prior to purchasing the house and lot in August 1961, petitioners and their family had vacationed at Sea Island on numerous occasions. On such occasions they had stayed at the hotel or had rented a cottage. In considering the purchase of the house on Sea Island, petitioners figured that, "at the rent they had to pay" for the rental of cottages from others, if they could acquire the property reasonably, they could pay for it and would also have property that was enhancing in value.

The Cottage Rental Department of the Sea Island Company has acted as agent for the rental of petitioners' property since 1963. It was petitioners' practice to list their house with the Cottage Rental Department for periods of six months at a time. In April 1966, they listed their

cottage as available for rental during the months of May through October at $1,200 per month. This included the peak rental season for property on Sea Island. Among other things, petitioners agreed:

> * * * that the cottage will not be removed from the list of houses available for rental, nor occupied unexpectedly by the owner, or friends, until he has contacted The Cloister Hotel or the Cottage Rental office to see if the house has been previously rented for conflicting periods.

No rental agreements or listing for other years were offered in evidence.

Petitioners' property was not advertised for rent either by petitioners or the Sea Island Company. Specific information relating to petitioners' place is furnished by the Cottage Rental Department only when a prospective tenant makes an inquiry and indicates a need for a cottage of the general description of this one. Most of the people renting have previously visted Sea Island or have friends who have visited there and are aware that cottages are available for rent through the rental department.

Records of the Sea Island Company show that petitioners' cottage was rented as follows:

Dates Rented	Rent Paid
April 20-29, 1963	$ 270
July 1-31, 1963	900
March 5—April 30, 1964	1,500
July 1-15, 1964	500
July 16-31, 1964	500
August 1-15, 1964	500
1965—None Shown	

April 1-30, 1966	1,200
July 1-31, 1966	1,200
March 3—April 3, 1967	1,400
July 1-31, 1967	1,200
August 5—September 7, 1967	1,200
December 28, 1967—Jan. 2, 1968	300
March 3—April 3, 1968	1,400
April 10-30, 1968	1,125
July 1-31, 1968	1,200
April 1-30, 1969	1,500

Petitioners kept no records of the dates the cottage had been occupied by them or members of their family. Admittedly it has been used by various members of the family at undisclosed times during each of the years since they have owned it. Clay liked to go to Sea Island to relax and play golf whenever he could get away. He has also entertained friends and business associates engaged in the insurance industry there. His wife and children have also entertained guests there. The following written statement furnished to respondent's agent by Clay Johnson indicates that members of his family occupied the cottage on six different occasions during the months of February, March, May, June, August and September in 1966:

COTTAGE 97—Sea Island Georgia 1966

Cottage 97 was rented for two months during 1966—April & July

This was the first year following a complete renovation of the cottage in order that tenants could be attracted.

During January of 1966 the cottage was vacant; however, from February 18 to March 27 Mrs. Johnson had several people as her guests, and it is hoped that some of them will be future renters. The guests included the Howard Willeys of Memphis, the Dr. William Blacks of Memphis, the David Hemingways of Connecticut, and the Andrews, Pattens and Smiths of Lookout Mountain.

From May 5 to May 13 the cottage was occupied by my daughter and her husband, Mr. & Mrs. Lonnie Wayne Farmer, as guests.

From June 1 to June 5 my daughter, Barbara, and a few of her friends occupied the cottage.

From June 16 to June 24 Mrs. Johnson and I occupied the cottage.

August 18 to August 22 the cottage was occupied by my daughter, Betsy, and a couple from Atlanta.

September 2 to September 8 the cottage also was occupied by members of my family.

During October, November and December the cottage was vacant.

Petitioners paid for all utilities, including electricity, water and telephone (except long distance calls by tenants). The utilities were kept on all the year round.

In late 1964 or early 1965 petitioners had the garage enclosed providing a maid's room, and installed laundry equipment.

On January 18, 1965, Clay Johnson wrote the Cottage Rental Department as follows:

I received a very nice letter from Miss Wanna B. Erion concerning the job that has been done to

enclose our garage and install a dryer, washer, etc. I was a bit surprised, however, to hear that so far as the cottage it would be "an injustice to offer it again for rental until it is completely refurbished."

It is true, of course, that we have not been able to get down to Sea Island for sometime. We had usually made a practice of visiting the island during the children's vacations. However, with our oldest daughter now 22 and spending the past few months in New York, with Barbara being a freshman at Sweet Briar, and Clay, Jr. at Baylor School, we as well as they have looked forward to being together at home on the mountain during these holidays. In the meantime I have had an unusually busy schedule, and we have just not been able to get away for a visit to Sea Island. I certainly hope that we will get to spend some time there before too long.

In the meantime, I wonder if you would be kind enough to give me some ideas as to what you think the cottage needs in the way of "refurbishing." The criticisms that we received in the past from cottage rentals have been primarily regarding air-conditioning and lack of laundry facilities. Though we do not have central air-conditioning, each room in the cottage as well as the garage apartment has been equipped with air-conditioning units, and we have now completed the laundry requirements.

Having just completed the laundry it seems somewhat strange that we would now get word that the cottage is just not rentable. I would appreciate hearing from you.

On January 21, 1965, the Department replied as follows:

It was good to hear from you. We have wondered what had happened to the Johnsons, as it has been

a long while since you and Mrs. Johnson were here, or since we heard from you. We can understand why after receiving your letter of January 18.

Wanna has written you a second letter listing in itemized form the numerous things that we feel are urgently necessary to bring the house up to Sea Island rental standards and to keep the house rented regularly. We do like repeat guests in the same cottages, and it has been quite sometime since the same families rented Cottage 97. The Nunnallys did return last summer but were not happy. A thermofax copy of Mr. Nunnally's letter to us is enclosed, as well as the one from Mr. Warner, who had your cottage last August.

Wanna and I do not mean to be derogatory in our criticism of the cottage, since actually, it has a great deal of charm structurally. In fact, there are no houses comparable to it on the Island and to us, it becomes increasingly so with so many new brick homes going up and all so much alike from an architectural viewpoint. However, we find that the newer cottages are in greater demand from year to year simply because of nicer furnishings and modern equipment. We are jealous for Cottage 97 with its impressive structural qualities and believe that you and Mrs. Johnson would want to upgrade it so as to make the entirety appealing to everyone who enters its portals.

The location of your cottage is ideal, and there would be no trouble in keeping it rented during the rental season if it were brought up to standard.

The laundry room is fine, and we do appreciate your untiring efforts to get the job accomplished to meet that demand from the renters.

Please give these matters your thoughtful and serious consideration, and if we can be of help in any way, please do not hesitate to call on us.

Incidentally, we have no Spring rentals for the cottage up to this point.

One of the previous renters said they were "not happy with the house." The other said "The condition and equipment of the cottage left something to be desired." Both asked about other places to rent. One asked whether any improvement in the petitioners' cottage would be made prior to August 1965.

During 1965 the petitioners made additional improvements in the cottage including central heating and air-conditioning, painting inside and out, and installation of new furniture, carpets and draperies. The cottage was not rented during 1965, and the petitioners did not use it while renovation was in progress.

On their tax return for 1965 the following improvements are listed as having been made and completed in 1965:

Nature	Cost
Remodeling	$ 5,684.23
Furniture	10,995.35
Carpets & Draperies	2,957.93
Central Heat & Air	3,541.34
Painting	2,826.34
Total cost	$26,005.19

The following invoices illustrate the redecorating that was done in the house

LOOKOUT MOUNTAIN ANTIQUE SHOP
Box 26
LOOKOUT MOUNTAIN, TENNESSEE

May 21, 1965

Mr. Clay Johnson—Sea Island Residence

Balance May 1 billing: Cabin Craft Rug		$660.00	
Sales Tax		19.80	$ 679.80
Pair Sofas @ $490.00	$980.00		
Less 10%	98.00		882.00
Sales Tax			26.46
Maison Tole Light Fixtures Second Floor			
Master Bed Room, 1 5-light ceiling fixture		$ 75.00	
Master Bed Room, 1 1-light ceiling fixture		30.00	
Master Bed Room, 2 standing lamps @ $45.00		90.00	
Girls' Room, 1 Bedside Lamp		40.00	
2 3-light ceiling fixtures, Girls' and Clay's room @ $60.00		120.00	
2 standing lamps @ $25.00, Girls' and Clay's room		50.00	
2 pin-up lamps, Clay's room @ $16.00		32.00	437.00
Sales Tax			13.11
4 Sconces, Dining Room, wired			90.00
Sales Tax			2.70
Hexagonal Vinyl Tile Floor Per Contract			887.00
Sales Tax			26.61
TOTAL			$3,044.68

Please make check payable Lookout Mountain Antique Shop, Special and mail to Mrs. Overton Dickinson, Lookout Mt., Tenn. [Pd 5/28/65]

1409 Oglethorpe St. Telephone 265-7985
BRUNSWICK, GA.

R. VAN DROSKEY

MEMBER INTERNATIONAL ART RESTORERS GUILD
ANTIQUES AND ART OBJECTS RESTORED—
FINE FURNITURE REFINISHING

5/17/65

Mrs. H. Clay Johnson
Lookout Mt.
Chattanooga, Tenn.

To remove all existing finish, make necessary repairs, and finish in 12 coat process Barcelona blue-green with gold decoration and glazed antique over all. All surfaces hand rubbed to dull satin finish. Drop leaves to table are finished in same color both sides as they are exposed when leaves are down.

1—10′ dining table in above with black lacquer base and gate legs	$167.00
1—6 drawer, 2 door buffet in same finish	155.00
1—Baker round coffee table w/brass trim, finished in hand rubbed black lacquer	85.00
	$407.00

The petitioners reported the following income and expenses on their 1965 and 1966 joint income tax returns:

Rental income 1965—none; 1966—$2,400.

Expenses	1965	1966
Rental Commissions	$ 807.17	$ 360.00
Taxes	5.00	841.03
Depreciation	4,515.95	6,840.64
Lawn Maintenance	917.07	1,097.50
Fuel	73.71	-0-
Telephone	111.15	133.50
Electricity	186.38	426.37
Miscellaneous	61.45	188.90
Repairs	746.32	506.40
Water	61.80	61.80
Painting	2,826.34	230.00
Total	$10,312.34	$10,686.14
Net loss	$10,312.34	$ 8,286.14

Depreciation was computed as follows:

Acquired	Description	Cost	Life Years	1965	1966
8-1-61	Property	$35,500.00	20	$1,775.00	$1,775.00
6 65	Remodeling	5,684.23	15	355.26	686.84
6 65	Furniture	10,995.35	6	1,570,76	2,879.73
6 65	Carpets & Draperies	2,957.93	5	492.99	887.38
6 65	Air Cond.	3,541.34	10	321.94	611.69
				$4,515.95	$6,840.64

The expenses claimed on petitioners' income tax returns for the years 1965 and 1966 covered the cost of operating the residence for twelve months in each year. No attempt was made by petitioners to allocate any portion of the expenses between personal use and expenses related to the period of time in which the house was actually rented.

The following schedule sets forth the rental receipts, depreciation, expenses and net losses relating to the property at Sea Island, Georgia reported on petitioners' joint Federal income tax returns covering the years 1961 through 1969:

Year	Gross Receipts	Depreciation	Expenses	Loss
1961	$ -0-	$ 739.58	$ 393.90	$ 1,133.48
1962	2,851.25	1,775.00	3,015.48	1,939.23
1963	2,333.65	1,775.00	2,264.39	1,705.74
1964	3,066.00	1,775.00	4,602.57	3,311.57
1965	-0-	4,515.95	5,796.39	10,312.34
1966	2,400.00	6,840.64	3,845.50	8,286.14
1967	3,800.00	6,008.11	3,877.95	6,086.06
1968	4,025.00	5,112.57	3,625.26	4,712.83
1969	5,250.00	4,343.02	9,391.77	8,484.79

In the statutory notice of deficiency respondent disallowed the total expenses and depreciation of $10,312.34 relating to the Sea Island, Georgia property claimed on petitioners' 1965 return. For the year 1966 respondent dis-

allowed the net loss claimed of $8,286.14. The reasons for the disallowances were stated in the statutory notice as follows:

> It is held that the losses of $10,312.34 and $8,286.14, claimed in your income tax returns for 1965 and 1966, respectively, as resulting from the rental of property located at Sea Island, Georgia, are not allowable because it is determined that the property was not held primarily for the production of income during those years and that expenses in excess of income were not incurred in a transaction entered into for profit. Accordingly, taxable income for the taxable years ended December 31, 1965, and December 31, 1966, is increased $10,312.34 and $8,286.14, respectively.

Opinion

The principal issue, common to each of these cases, is whether the respective petitioners realized taxable income upon the transfer of 50,000 shares of stock having a basis of $10,812.50 and a fair market value of $500,000 to trusts for the benefit of their respective children, where such stock had been pledged as collateral security for bank loans, obtained one or two days prior to such transfers, in the amounts of $200,000 (in two of the cases) and $175,000 (in the other case), the notes evidencing the loans were endorsed "without personal liability," the trustees assumed payment of the loans by substituting their notes for those of the petitioners which were then stamped as paid, and the petitioners used the proceeds of the loans for their own personal purposes.

Respondent determined that the petitioners in each case realized long-term capital gains to the extent that the amount of the loans obtained by them exceeded their

basis in the stock transferred. The burden is upon the petitioners to show that respondent's determination is erroneous. Rule 32, Tax Court Rules of Practice.

The determination of this issue turns primarily upon the question of whether the transfers of the Interstate stock to the trusts were in part sales and in part gifts, as contended by respondent, or were merely gifts of the difference between the fair market value of the stock transferred and the loans to which the stock was subject.

Petitioners argue: (1) that "the pledging of property to secure a loan on which the borrower is not personally liable is not a taxable event for U. S. income tax purposes"; (2) that "the making of a gift is not a taxable event for U. S. income tax purposes even though the property given is subject to a loan in excess of the donor's basis for the property"; (3) that "the loan and gift were separate transactions, however, even if they are considered together, the transaction is not taxable for U. S. Income tax purposes." Respondent's position is that "petitioners realized a taxable gain on these transactions to the extent of the excess loan proceeds over the basis in the stock transferred since (1) in substance each one of the three transactions constitutes in part a sale and in part a gift, and (2) there is no statute specifically exempting such realized gain from taxation."

We agree with petitioners that the mere pledging of property to secure a loan is not a taxable event and this is so whether or not the borrower is personally liable on the loan, since in such cases there has been no transfer of title and hence no sale or other disposition of the property. *Old Colony Trust Associates v. Hassett* [45-1 USTC ¶ 9309], 150 F. 2d 179 (C. A. 1, 1945); Mertens, Law of Federal Income Taxation (1969 Revision), § 5.12.

Respondent does not contend otherwise, but correctly points out that this is not an issue in the present case.

We also agree that the mere making of a gift is not of itself a taxable event for Federal income tax purposes. Where, however, as here, property is given to another subject to a loan obtained by the donor in excess of his adjusted basis in the property transferred, and the transferee pays or assumes payment of the loan, the transaction is in part a gift and in part a sale. To the extent the fair market value of the property transferred exceeds the amount of the loan it is a net gift subject only to the payment of the gift taxes thereon. To the extent, however, that the loan exceeds his basis in the property transferred it is a sale and the transferor has realized income subject to capital gain taxes.

Contrary to petitioners' contentions, the making of the loans and the transfers of the stock pledged to secure such loans to trusts for the benefit of their children were not separate unrelated transactions, but were part and parcel of an overall plan whereby the petitioners sought to realize a substantial portion of the appreciated value of the stock for themselves without tax liability, and at the same time make gifts of the stock to trusts for the benefit of their children (and thus keep the stock in the family), the gift taxes on which would be (and as ultimately determined and paid were) substantially less than their loans, and also substantially less than the excess of the loans over basis. The borrowings in each case were obtained from the same bank on the same day (except as to the $25,000 additional loan obtained by Clay Johnson on the next day). In each case a 30-day note was given for the amount of the loan, secured by 50,000 shares of Interstate stock and the "Direct Account" of each borrower was charged with interest for 30 days. In each case the

co-trustees (including the wife-petitioner) replaced the trustor's notes with their own notes within 30 days and the petitioners' notes were stamped as "paid." The co-trustees in each case also gave their notes for the amount of the interest charged to the "Direct Account" of each of the borrowers, and such accounts were then shown as having zero balances. In each case the borrower retained the full amount of the loan obtained by him and used the proceeds thereof for his own personal purposes.

Section 61(a) of the Internal Revenue Code of 1954[2] provides: "Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including * * * (3) Gains derived from dealings in property; * * *.

Section 1001(a) provides: "The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis * * *." And section 1001(b) provides: "The amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received."

Section 1.1001-1(e)(1) of the Income Tax Regulations provides that "Where a transfer of property is in part a sale and in part a gift, the transferor has a gain to the extent that the amount realized by him exceeds his adjusted basis in the property."

In *Crane v. Commissioner* [47-1 USTC ¶ 9217], 331 U. S. 1 (1947), the taxpayer inherited real property consisting of an apartment building and lot, the fair market

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2. All statutory references herein are to the Internal Revenue Code of 1954, as amended, unless otherwise indicated.

value of which equaled an encumbrance to which it was then subject. She took the property subject to the mortgage but did not assume or become personally liable for the obligation. After her husband's death, she continued to operate the property for nearly seven years, during which period she reported the gross rentals as income and claimed and was allowed deductions for taxes and operating expenses, and for depreciation on the building. The allowable depreciation during the period the taxpayer held the property was $28,045.10 and her basis in the property was reduced by this amount. Taxpayer sold the property, subject to the mortgage, to a third party for $3,000 cash, and paid $500 expenses of sale. She reported one-half the net cash as taxable gain, subject to capital gains tax, on the theory that the "property" she acquired and sold was only the equity, which had a zero value when she received it and that when she sold the equity the amount realized on the sale was the net cash, or $2,500. The Supreme Court held that "the amount of the mortgage is properly included in the 'amount realized' on the sale."

In response to the argument that the amount of the mortgage was not includable in the "amount realized" upon the transfer because she was not personally liable on the mortgage, the Supreme Court stated:

> *we think that a mortgagor, not personally liable on the debt, who sells the property subject to the mortgage and for additional consideration, realizes a benefit in the amount of the mortgage as well as the boot.* If a purchaser pays boot, it is immaterial as to our problem whether the mortgagor is also to receive money from the purchaser to discharge the mortgage prior to sale, or whether he is merely to transfer subject to the mortgage—it may make a difference

> to the purchaser and to the mortgagee, but not to the mortgagor. Or put in another way, we are no more concerned with whether the mortgagor is, strictly speaking, a debtor on the mortgage, than we are with whether the benefit to him is, strictly speaking, a receipt of money or property. *We are rather concerned with the reality that an owner of property, mortgaged at a figure less than that at which the property will sell, must and will treat the conditions of the mortgage exactly as if they were his personal obligations. If he transfers subject to the mortgage, the benefit to him is as real and substantial as if the mortgage were discharged, or as if a personal debt in an equal amount had been assumed by another.* [Footnotes omitted].[3] [Emphasis supplied].

Petitioners contend that the *Crane* case is not applicable in the present case for the reason that it was concerned with a sale of property and not a gift. This contention, however, ignores the well established rule that the incidence of taxation is controlled by the substance of a transaction rather than its form.

In *Weiss v. Stearn* [1 USTC ¶ 94], 265 U. S. 242 (1924), the Supreme Court stated:

> Questions of taxation must be determined by viewing what was actually done, rather than the declared purpose of the participants, and when applying the provisions of the Sixteenth Amendment and income laws enacted thereunder we must regard matters of substance and not mere form.

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3. The Court indicated in footnote 37 that a different problem *might* be encountered if the value of the property was less than the amount of the mortgage, but stated that was not the case there. It is also not the case here.

In *Commissioner v. Court Holding Co.* [45-1 USTC ¶ 9215], 324 U. S. 331, 334 (1945), the Supreme Court stated:

> The incidence of taxation depends upon the substance of a transaction. The tax consequences which arise from gains from a sale of property are not finally to be determined solely by the means employed to transfer legal title. Rather the transaction must be viewed as a whole and each step from the commencement of negotiations to the consummation of the sale is relevant. * * * To permit the true nature of a transaction to be disguised by mere formalisms, which exist solely to alter tax liabilities, would seriously impair the effective administration of the tax policies of Congress.

In the *Crane* case, in holding that "the amount of the mortgage is properly included in the 'amount realized' on the sale," the Supreme Court was concerned with the economic realities of the transaction whereby the mortgagor had obtained real and substantial benefits rather than the form in which the transfer had been made.

In that case, the taxpayer had taken depreciation deductions amounting to $28,045.10 and her basis in the property was correspondingly reduced. Accordingly, under the Supreme Court's decision, when she sold the property subject to the mortgage she realized real and substantial benefits to the extent the mortgage exceeded her adjusted basis, in addition to the small amount of cash received. In the present case, the petitioners had obtained loans, in the amounts of $200,000 in two of the cases and $175,000 in the other case, for which each pledged stock having a fair market value of $500,000 and a basis of $10,812.50. They then transferred the stock to trusts for the benefit of their children. The trustees substituted their notes for those of the petitioners; petitioners' notes were stamped

as paid; and their loan accounts at the bank were shown as having zero balances. We think the rationale of the *Crane* case is applicable here and that as the result of these transactions two of the petitioners realized capital gains on their stock in the amount of $189,187.50 and the other petitioner realized capital gains in the amount of $164,187.50.

The rationale of the *Crane* case has been applied by this and other Courts in situations analogous in many respects to the present case.[4]

In *Joseph B. Simon,* [Dec. 23,694] 32 T. C. 935, aff'd. [61-1 USTC ¶ 9136] 285 F. 2d 422 (C. A. 3, 1960), the taxpayer borrowed $120,000 secured by a mortgage on real property owned by him. The terms of the loan specifically provided that the lender could look only to the mortgaged property for recovery in the event of default. Three months after the loan the taxpayer conveyed the mortgaged property to Exco, a corporation in which he owned 50

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4. For articles relating to the *Crane* case, and the income tax consequences of the transfer of property subject to encumbrances in excess of the transferor's adjusted basis, see: Disposition of Property Mortgaged in Excess of Basis, by Mortimer Berl, N. Y. U. 19th Annual Institute on Federal Taxation, 1033, 1040-1045 (1961); Note on Assumption of Indebtedness by a Donee—Income Tax Consequences, 17 Stanford Law Review 98 (Nov. 1964); Comment: Income Tax Consequences of Gifts of Property Encumbered in Excess of Basis, 7 U. C. L. A. Law Review 770, 772-779 (1960); Basis and Amount Realized Under *Crane;* A Current View of Some Tax Effects of Mortgage Financing, by Louis A. Del Cotto, 118 Univ. of Penn. Law Review 69 (1969); Federal Tax Implications of Gifts Net of Gift Tax, by Joseph R. Lowenstein, 50 Taxes—The Tax Magazine 525 (Sept. 1972). Contra: Mortgages in Excess of Basis by Melvin S. Spears, 1959 Southern California Tax Institute 883 (1959), but note criticism thereof in 7 U. C. L. A. Law Review, *supra,* footnote 16, at 775.

See also *Rev. Rul.* 70-626, *C. B.* 1970-2, 158, which held on authority of *Crane v. Commissioner, supra,* that "a gift or donation of property pledged to secure a debt, the amount of which is less than the fair market value of such property, is a transfer of property in part a sale and in part a gift within the meaning of section 1.1011-1(e) of the Regulations.

percent of the common stock, for a recited consideration of $100 (which was never paid), but subject to the mortgage, the unpaid principal of which was then $119,098.22. On the date of the conveyance to Exco, taxpayer's adjusted basis in the property was $82,205.17 and the fair market value of the property was substantially in excess of the mortgage indebtedness. The taxpayer claimed that the transfer of the property was a nontaxable contribution of capital under the 1939 Code. This Court held that the transfer was in substance a sale to the extent of the difference between the amount of the mortgage indebtedness and taxpayer's basis.[5]

In *First National Industries, Inc. v. Commissioner* [69-1 USTC ¶ 9145], 404 F. 2d 1182 (C. A. 6, 1968), affirming a Memorandum Opinion of this Court, certiorari denied 394 U. S. 1014 (1969), the taxpayer, one of six corporations owned and controlled by a seventh nonprofit charitable corporation (Foundation), obtained a bank loan in the amount of $750,000 for which it pledged as security 1,000 shares of stock it owned in an entirely separate company. Its basis in this stock was $100,000. Taxpayer transferred this stock to Foundation, which took it subject to the loan. Foundation sold the stock to the issuing company for redemption, receiving $250,000 in cash and the company's note in the amount of $705,374.29. Foundation sold the note to the bank and advanced $700,000 of the proceeds to a subsidiary. This subsidiary made payments on its indebtedness to three other subsidiaries. They in turn made payments on their indebtedness to the taxpayer, and taxpayer paid off its note to the bank in the amount of $700,000. It was held that the original transfer of the stock by the taxpayer to its parent corpora-

5. See also *Magnolia Development Corp.*, [Dec. 24,331], 19 T. C. M. 934 (1960).

tion was basically equivalent to a sale and that the taxpayer realized capital gain on the transaction. In so holding, the Court of Appeals (at page 1186) stated:

> A donor taxpayer is not chargeable for income on account of a gift of property which has appreciated in value over the base at which he held it (*Humacid Co.* [Dec. 26,927], 42 T. C. 894, 913 (1964)), but where donated property continues to be subject to a mortgage a gain may result to the donor under certain circumstances. *Joseph B. Simon* [Dec. 23,694], 32 T. C. 935 (1959), aff'd, [61-1 USTC ¶ 9136] 285 F. 2d 422 (3rd Cir. 1960). Since the amount of the mortgage on property is part of its sale price even though the purchaser does not assume the mortgage (*Crane v. Commissioner of Internal Revenue* [47-1 USTC ¶ 9217], 331 U. S. 1, 67 S. Ct. 1047, 91 L. Ed. 1301 (1947)), because the purchaser will be required in some way to discharge the mortgage, a transfer of property subject to such a mortgage may in substance constitute a receipt by the transferor of the amount of the mortgage on the property if the transferee does in fact pay the indebtedness secured by the mortgage. * * *

In *R. C. Malone v. United States* [71-1 USTC ¶ 9475], 326 F. Supp. 106 (N. D. Miss., 1971), aff'd. per curiam [72-1 USTC ¶ 9217] 455 F. 2d 502 (C. A. 5, 1972), the taxpayer conveyed farm land having an adjusted basis of $13,650 and a fair market value of $57,485 to an irrevocable trust for the benefit of his grandchildren, subject to two loans which he had previously obtained from the Federal Land Bank of New Orleans in the total amount of $32,000, secured by the farm property. The trustees accepted the trust property subject to the mortgage indebtedness and thereafter paid annual installments on the

bank loans from rental income received from the lease of the farm lands. The taxpayer used the proceeds of the bank loans for his own personal purposes unrelated to the trust property. It was held that the transfer of the mortgaged property to the trust was a *gift* to the extent of the value of the property in excess of the debt and was a taxable *sale* to the extent of the difference between the mortgage debt and the taxpayer's adjusted basis in the property.

The present case is similar in many respects to the *Malone* case and requires a similar conclusion. For Federal income tax purposes, it is immaterial whether the stock was transferred subject to the loans or whether the transferees assumed payment of the loans. In either case, as a matter of economic reality, the transferees must see to it that the loans are paid in order to protect their equity in the stock. In either case the benefit to the transferor was "real and substantial." *Crane v. Commissioner, supra*; *First National Industries, Inc. v. Commissioner, supra.*

We hold that the transfers in question constituted in part a gift and in part a sale. To the extent that the fair market value of the stock transferred by each of the petitioners exceeded the amount of his loan it was a gift subject only to the payment by him of the gift taxes thereon, which have been paid and are not an issue herein. To the extent the transfers were subject to the loans they were sales and petitioners each realized capital gains in the amount his loan exceeded his basis in the stock.

Richard H. Turner [Dec. 28,814], 49 T. C. 356 (1968), aff'd. per curiam [69-1 USTC ¶ 9416] 410 F. 2d 752 (C. A. 6, 1969), relied upon by petitioners, does not require a

different conclusion. In that case, the taxpayer transferred certain shares of stock to her children and to trusts for the benefit of her grandchildren, on condition that the various recipients pay their pro rata share of the resulting gift tax liabilities which in each instance exceeded the donor's basis. It was held that the donor intended and in fact made a net gift to each recipient in the amount of the value of the shares transferred less the amount of the gift taxes and that the transfers were not part sales and part gifts.

The instant case is distinguishable from the *Turner* case both on the facts and the issues presented. The transfers in the present case were not conditioned on the payment of the gift tax liabilities by the recipients and no issue involving the payment of gift taxes is presented herein. Nor was there any reservation or retention by the donors in the present case, of any right or interest in the corpus or income of the trusts such as was found by the Court in the *Turner* case. Nor, in our opinion, are the loans in the present case to be equated with the gift tax liabilities in the *Turner* case. The record herein does not support petitioners' statement, on brief, that "the loans incurred were simply enough to meet possible U. S. and Tennesee gift tax liabilities." As shown by the schedule of gift taxes set forth in our findings, the total gift taxes paid by Joseph and Margaret were $147,072.61; total gift taxes paid by Clay and Betty were $125,550; and the total gift taxes paid by David and Elise were $125,177. Their loans exceeded the gift taxes as initially reported by them and ultimately paid by $52,927.49, $49,450 and $74,823, respectively. Petitioners have offered no explanation for such excesses if the only purpose of the loans was to secure money with which to pay their gift tax liabilities. Finally, unlike in the *Turner* case, we have

found, on the basis of all the facts presented and consonant with the authorities hereinbefore discussed, that the transfers here in question were in reality part sales and part gifts.

The Sea Island Property

The remaining issue concerns the petitioners H. Clay Evans Johnson and Betty Mead Johnson only. On their income tax returns for 1965 and 1966, they claimed deductions in the amounts of $10,312.34 and $8,286.14, respectively, as net losses incurred in connection with the maintenance and operation of a residence at Sea Island, Ga. Respondent determined that the deductions claimed were not allowable because the property was not held primarily for the production of income during those years and the expenses in excess of income were not incurred in a transaction entered into for profit. In the absence of any rental income from the property for the year 1965, the entire amount of the depreciation and expenses claimed for that year was disallowed. For the year 1966, the amount disallowed represented the excess of the total depreciation and expenses claimed ($10,686.14) over the $2,400 of rental income received from the property for that year.

Petitioners have the burden of establishing that respondent's determination is erroneous. Rule 32, Tax Court Rules of Practice; *Carkhuff v. Commissioner* [70-1 USTC ¶ 9387], 425 F. 2d 1400 (C. A. 6, 1970) affirming a Memorandum Opinion of this Court [Dec. 29,523(M)]; *Drybrough v. Commissioner* [67-1 USTC ¶ 9340], 376 F. 2d 350, 360 (C. A. 6, 1967), affirming on this point [Dec. 26,962] 42 T. C. 1029.

The issue presented is whether the petitioners are entitled to the expense and depreciation deductions under the provisions of sections 162, 167 and 212 of the Internal

Revenue Code of 1954, the applicable portions of which are set forth in the margin.[6] The resolution of this issue requires a determination of whether the acquisition and holding out of the Sea Island property for rental purposes by petitioners constitutes a "trade or business" or whether that property was "held for the production of income," within the purview of the above sections.

It is recognized that the holding of a single property for rent may constitute a trade or business. *Anders I. LaGreide* [Dec. 20,721], 23 T. C. 508, 512 (1954); *Leland Hazard* [Dec. 15,273], 7 T. C. 372 (1946); also that property held for rental purposes may be held for the production of income within the provisions of section 212, *William C. Horrmann* [Dec. 18,651], 17 T. C. 903 (1951). In determining whether the holding of property for rental is a trade or business within the meaning of section 162, or is a holding of property for the production of income within the meaning of section 212, the intention of the taxpayers as to the use of the property is of paramount importance.

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6. SEC. 162. TRADE OR BUSINESS EXPENSES.

(a) In general.—There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business * * *

* * *

SEC. 167. DEPRECIATION.

(a) General Rule.—There shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)—

(1) of property used in the trade or business, or

(2) of property held for the production of income.

SEC. 212. EXPENSES FOR PRODUCTION OF INCOME.

In the case of an individual, there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year—

* * *

(2) for the management, conservation, or maintenance of property held for the production of income; * * *

In order for the petitioners to be entitled to recover herein, it was necessary that they demonstrate they had a profit-seeking motive in acquiring and holding the Sea Island property. If the predominant purpose and use of the property was for recreation, a hobby or some other non-profit motive, rather than to derive income, they are not entitled to the deductions claimed. *Carkhuff v. Commissioner, supra*; Income Tax Regs., section 1.212-1(c). See also *Schley v. Commissioner* [67-1 USTC ¶ 9322], 375 F. 2d 747 (C. A. 4, 1967), affirming a Memorandum Opinion of this Court [Dec. 27,358(M)]; *Marcell N. Rand* [Dec. 24,377], 34 T. C. 1146, 1150 (1960). While the absence of a profit is not necessarily determinative, the operation must be of such a nature that in good faith, the taxpayers could expect a profit. *Carkhuff v. Commissioner, supra*; *Lamont v. Commissioner* [65-1 USTC ¶ 9124], 339 F. 2d 377 (C. A. 2, 1964), affirming a Memorandum Opinion of this Court [Dec. 26,603(M)]. See also *Henry P. White* [Dec. 20,611], 23 T. C. 90, affirmed per curiam [56-1 USTC ¶ 9139] 227 F. 2d 779 (C. A. 6, 1955), certiorari denied 351 U. S. 939.

Whether the petitioners acquired and held the Sea Island property for rent primarily for the purpose of making a profit is a question of fact to be determined from all the facts and circumstances of the case. No single factor is controlling but greater weight is to be given to objective facts than to the taxpayer's mere expression of intent.

Prior to their purchase of the house and lot on August 1, 1961, petitioners and their children had vacationed at Sea Island on numerous occasions. On such occasions they had either stayed at the Cloister Hotel or had rented a cottage. In answer to the question "What made you get into this particular piece of property?" Clay testified:

> Sir, I have been to Sea Island on several numerous occasions, as a matter of fact, before that, as a renter, myself. I have stayed at the Cloister, and I have also rented cottages. And I figured at the rent I had to pay, if I stood on a piece of property, I could acquire reasonably, I would be able to—not only one day be able to pay for it, but I would have a property that was enhancing in value every year.

Later, on cross-examination, he testified:

> We bought it with the idea that we were going to rent the house, and if once in a long time, the house would not be rented and we could go, we did.

Petitioner was equally imprecise and unclear in his testimony concerning other matters. At no time did he precisely and clearly state that he bought the Sea Island property for the primary purpose of making a profit. Considering all of the facts and circumstances, including the factors hereinafter discussed, we are convinced that petitioners bought the property primarily in order to minimize their vacation expenses and to recoup some of the cost of maintaining and operating a vacation home of their own.

Petitioner had no knowledge and apparently made no investigation prior to purchasing the property to determine whether the property had ever been rented by the former owner, or if so, for how much.

The rental agreements which petitioners entered into with the Cottage Rental Department of the Sea Island Company did no more than to make petitioners' cottage available for rental by the Cottage Rental Department as petitioners' agent, at such times as it was not being used or occupied by petitioners, members of their family,

or friends. Petitioners agreed not to remove the cottage from the list of houses available for rent or to occupy the cottage unexpectedly without notice. They were at liberty, however, to use the property themselves at any time they chose except when it was actually occupied or contracted for by a renter.

Petitioners' property was not advertised for rent either by petitioners or the Sea Island Company. Specific information relative to petitioners' place was furnished by the Cottage Rental Department only when a prospective tenant made an inquiry and indicated a desire to rent a cottage of the general description of this one.

Petitioners paid all expenses for the maintenance and operation of the property as a vacation home, including the maintenance of the grounds and all utilities such as electricity, water and telephone (except long distance calls by tenants). The utilities were kept on all the year round. No allocation was made of any of the claimed expenses between the times the property was used by petitioners or members of their family, and the periods when the cottage was actually rented.

It does not appear from the evidence presented that petitioners kept any books of record showing the expenses of maintaining and operating the property or of the income received from rentals, such as would normally be expected of one engaged in a transaction for profit. The only evidence relating to the rental of the property was information obtained from the rental cards maintained by the Cottage Rental Department showing the dates the cottage was rented and the rent paid therefor, during the period from April 20, 1963, to April 30, 1969. There is no evidence as to when the property may have been rented prior to April 20, 1963.

Petitioners admitted they kept no records of the times the cottage was occupied by them or members of their family. The statement given to respondent's agent by Clay, relating to use of the property by members of his family in 1966, was evidently prepared by him from memory after the investigation of the returns herein was begun. Clay's testimony that he and members of his family used the property an average of only one month out of each year since it was purchased in 1961 is hardly acceptable, particularly for the years 1961, 1962 and 1963 when the children were young and it might reasonably be expected the family would vacation together and they had only recently purchased a vacation home of their own in a highly desirable resort area. The property was not used by them in 1964 as much as in prior years, apparently because the oldest daughter was in New York for a number of months, the youngest daughter was a freshman at Sweet Briar, and the son was attending Baylor School. Also Clay had an unusually heavy schedule during this year. The eye trouble for which the mother, Betty Mead Johnson, later underwent operations for cataracts, may also have been a factor.

As to the year 1965, petitioner testified, and the records of the Cottage Rental Department indicate that the cottage was not rented during this year. Clay testified it was not rented, or used by him or members of his family, during the entire year 1965, because of the renovations or improvements being made. The invoices for new rugs, draperies, lamps and the refinishing of furniture were dated in May 1965, and petitioners' returns state the remodeling, etc. was "acquired" in June 1965. We think it reasonable to presume that improvements such as painting, plastering, installation of central air conditioning and tile flooring were completed prior to the installation of new rugs, draperies and furnishings. Petitioner's testimony

does not convince us that the property was not useable by them, or rentable, after June 1965.

We are also not convinced that the improvements in question were made primarily for the purpose of making a profit. The extent and quality of the improvements, including expensive rugs, sofas and draperies, and twelve coats of hand-rubbed finishing on furniture, belie such a purpose. The rental of the property for only two months during the taxable year 1966, the year following the improvements, and the use of the property by members of the family on six different occasions, for a total of 73 days in 1966, is contra-indicative of a profit motive for such extensive outlays.

Other factors to be considered, though not of themselves controlling, are the financial status of the petitioners and the standard of living to which they were accustomed. The petitioners are obviously persons of substantial means and accustomed to living in pleasant surroundings. Their principal residence was located at 1300 Scenic Highways on "Lookout Mountain." In 1965, even after transferring 50,000 shares (valued at $500,000) of income-producing stock to trusts for the benefit of their children in March 1965, they had income in excess of $109,000, and in excess of $132,000 in 1966. Although the improvements made to petitioners' Sea Island property no doubt made it more attractive to potential renters, the extent and character of the improvements are more indicative of an intention to satisfy their personal tastes and comfort rather than of an intent to make a profit. *Carkhuff v. Commissioner, supra.*

Considering all of the facts and circumstances, we hold that the Sea Island property was not acquired by petitioners or held by them during the taxable years primarily for the purpose of making a profit and accordingly,

they are not entitled to the deductions claimed in excess of the amount allowed by respondent.

Decisions will be entered for the respondent.

DECISION OF THE UNITED STATES TAX COURT IN NO. 5602.69

(Entered March 12, 1973)

Docket No. 5602-69

UNITED STATES TAX COURT
WASHINGTON

JOSEPH W. JOHNSON, JR. and
MARGARET A. JOHNSON,
Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

DECISION

Pursuant to the determination of the Court, as set forth in its Findings of Fact and Opinion filed March 12, 1973, it is

ORDERED AND DECIDED: That there is a deficiency in income tax due from the petitioners for the taxable year 1965 in the amount of $47,660.02.

Entered March 12, 1973.

/s/ J. GREGORY BRUCE
Judge

DECISION OF THE UNITED STATES TAX COURT IN NO. 5638.69

(Entered March 12, 1973)

Docket No. 5638-69

UNITED STATES TAX COURT
WASHINGTON

H. CLAY EVANS JOHNSON and
BETTY MEAD JOHNSON,
Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

DECISION

Pursuant to the Determination of the Court, as set forth in its Findings of Fact and Opinion filed March 12, 1973, it is

ORDERED AND DECIDED: That there are deficiencies in income tax due from the petitioners for the taxable years 1965 and 1966 in the amounts of $42,774.26 and $9,440.64, respectively.

Entered Mar. 12, 1973.

/s/ J. GREGORY BRUCE
Judge

DECISION OF THE UNITED STATES TAX COURT IN NO. 5639.69

(Entered March 12, 1973)

Docket No. 5639-69

UNITED STATES TAX COURT
WASHINGTON

DAVID F. S. JOHNSON and
ELISE E. JOHNSON,
Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

DECISION

Pursuant to the determination of the Court, as set forth in its Findings of Fact and Opinion filed March 12, 1973, it is

ORDERED AND DECIDED: That there is a deficiency in income tax due from the petitioners for the taxable year 1965 in the amount of $50,832.04.

Entered Mar. 12, 1973.

/s/ J. GREGORY BRUCE
Judge

OPINION OF THE COURT OF APPEALS

(Filed April 9, 1974)

Nos. 73-1908, -1909 & -1910

UNITED STATES COURT OF APPEALS
FOR THE SIXTH CIRCUIT

JOSEPH W. JOHNSON, JR. and MARGARET A. JOHNSON,
Petitioners-Appellants,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent-Appellee.

H. CLAY EVANS JOHNSON and BETTY MEAD JOHNSON,
Petitioners-Appellants,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent-Appellee.

DAVID F. S. JOHNSON and ELISE E. JOHNSON,
Petitioners-Appellants,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent-Appellee.

APPEAL from the United States Tax Court.

Before: CELEBREZZE, PECK and ENGEL, *Circuit Judges.*

CELEBREZZE, Circuit Judge. This case presents the question of a donor's income tax liability upon the transfer to a

trust of highly appreciated stock subject to debt, where the proceeds of a loan which the stock secures are received by the donor and a large portion of the proceeds is used to pay the donor's gift taxes on the transfer.

Joseph W. Johnson, David F. S. Johnson, and H. Clay Evans Johnson[1] developed Interstate Life and Accident Insurance Company into a successful enterprise. In March 1965, each taxpayer decided to give a substantial block of Interstate stock to his children. Dr. Joseph Johnson's transactions will be described herein, as the prototype for what all three taxpayers did, with figures rounded off for purposes of simplification.[2]

On March 9, 1965, Dr. Johnson obtained $200,000 from a bank by signing a note. The note was secured by 50,000 shares of Interstate stock, "without personal liability" of Dr. Johnson. On March 11, he established an irrevocable trust

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1. The Johnsons' wives are parties to the litigation because joint returns were filed in each case.

2. The Tax Court's Opinion, reported at 59 T.C. 791 (1973), describes the transactions in great detail.

The actual figures are as follows:

	Fair Market Value of Stock Transf'd without debt	Basis of Stock Before Transfer	Loan Taken Out	Gift Tax Paid (State and Federal)	Capital Gain Asserted
seph hnson	in excess of $500,000	$10,812.50	$200,000	$147,072.51	$189,187.50
vid hnson	in excess of $500,000	$10,812.50	$200,000	$125,177	$189,187.50
y nson	in excess of $500,000	$10,812.50	$175,000	$125,550	$164,187.50

Taxpayers concede on appeal that they have realized a capital gain equal to the excess of the loan proceeds not used to pay their gift taxes over basis. Thus, the only disputed deficiencies on appeal are those on capital gains equal to the amount of gift taxes paid by each taxpayer.

for his children's benefit and transferred to it his rights in the 50,000 shares. His wife and the lending bank were appointed trustees.

On April 8, the trustees executed a note which cancelled Dr. Johnson's note and opened a $200,000 debit account in the trust's name, with the 50,000 shares pledged as collateral.

When these transactions were completed, Dr. Johnson had $200,000 in cash, and the trust had stock worth over $500,000, encumbered by a $200,000 note. Dr. Johnson later paid gift taxes of $150,000, leaving him $50,000 of cash and no obligation on the note.

On August 13, 1969, the Commissioner of Internal Revenue mailed deficiency notices to the taxpayers, asserting that each had realized long-term capital gain in the amount that the loan proceeds exceeded the basis in the stock transferred ($200,000 minus $10,000). Taxpayers contested the deficiencies in the Tax Court, arguing that because the transfer of stock to the trust constituted a "net gift," they "realized" no income upon the transfer.

The Tax Court rejected this argument, relying instead on "the *Crane* doctrine"—in broad terms, that the shedding of a liability constitutes the realization of income within § 1001, Int. Rev. Code of 1954. To reach this result, the Tax Court felt it necessary to decide whether the transfers of Interstate stock to the trusts were "in part sales and in part gifts" or "merely gifts of the difference between the fair market value of the stock transferred and the loans to which the stock was subject." 59 T.C. at - - -. The Tax Court concluded,

> "We hold that the transfers in question constituted in part a gift and in part a sale. To the extent that the fair market value of the stock transferred by each

of the petitioners exceeded the amount of his loan it was a gift subject only to the payment by him of the gift taxes thereon, which have been paid and are not an issue herein. To the extent the transfers were subject to the loans they were sales and petitioners each realized capital gains in the amount his loan exceeded his basis in the stock." 59 T.C. at —

By arriving at its conclusion via this route, the Tax Court distinguished *Turner v. Commissioner of Internal Revenue*, 49 T.C. 356 (1968), *aff'd per curiam*, 410 F.2d 752 (6th Cir. 1969). *Turner* seems to have been interpreted for the proposition that when a donor makes a "net gift" to a recipient and requires the donee to pay his gift tax liability, the payment of the donor's gift tax is not taxable as income to the donor. 59 T.C. at —[3] In *Turner*, the donor required the donee to pay his gift tax out of the gift's proceeds. In the instant case the Tax Court found that the transfers were not conditioned on the recipients' payment of gift taxes, that the donors reserved no interest in the trust corpora, and that the loans herein were not to be equated with the gift tax liabilities in *Turner* (since the loan proceeds significantly exceeded the gift taxes paid). The Tax Court concluded,

"Finally, unlike in the *Turner* case, we have found, on the basis of all the facts presented and consonant with the authorities hereinbefore discussed, that the

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3. This conclusion has been reached by certain commentators, who see the tax-planning opportunity by this view of the *Turner* case. *See, e.g.*, Kopp, "Gifts Subject to Donee Payment of Tax: Timing, Risks and Computations," 27 N.Y.U. Inst. Fed. Tax. 275, 397 (1969). Other commentators have not viewed the *Turner* decision as standing for so broad a principle. *See, e.g.*, Lowenstein, "Federal Tax Implications of Gifts Net of Gift Tax," 50 Taxes 525 (1972). No difficulty of taxpayer reliance on *Turner* is involved herein, since the relevant events occurred four years before the *Turner* decision.

transfers here in question were in reality part sales and part gifts." 59 T.C. at —.

Taxpayers concede on appeal that the *Crane* doctrine applies to the extent of $50,000 received through Dr. Johnson's transactions, but only to this extent. Asserting the familiar doctrine that "substance controls over form," they argue that their intent and the results of their transactions are identical to the *Turner* situation, so long as they concede that the $50,000 received in excess of gift tax liability minus the basis of the transferred shares should be taxed as a capital gain. Thus, they argue that the $150,000 which was received and used to pay the gift tax liability should escape income taxation.

Were we to view the *Turner* case in such broad terms as taxpayers assert, it would be difficult to distinguish this case from *Turner*. To be sure, the factors which the Tax Court found distinguishing are present. But to the extent the loan proceeds were used to pay the gift tax on the transfer, these features have little distinguishing force. Indeed, to state that in this case the transactions were "in reality part sales and part gifts" is to do nothing more than assert a conclusion. The fact is that these taxpayers, assisted by attentive tax counsel, attempted to raise cash to pay their gift taxes without themselves incurring taxable gain from transactions needed to raise the cash. This is what the *Turner* taxpayers attempted to do and succeed [sic] in doing. In the murky tax-planning days of the early 1960's,[4] the *Turner* lawyers

4. For examples of the guesswork of planners in this area, at the time the *Turner* and Johnson transactions were being undertaken, 1960-61 and 1965, respectively, *contrast* Comment, "Income Tax Consequences of Gifts of Property Encumbered in Excess of Basis," 7 U.C.L.A. L. Rev. 770, 774 (1960), and Note, "Assumption of Indebtedness by a Donee — Income Tax Consequences," 17 Stan. L. Rev. 98, 105 (1964) *with* Palmer, "Tax Saving Through Charitable Giving," 36 Taxes 40 (1958), and Spears, "Mortgages in Excess of Basis," 1959 So. Cal. Tax. Inst. 883, 902.

advised one procedure and the lawyers in this case advised another. For the results to diverge diametrically, we should be forced to this conclusion by the words or policies of the Internal Revenue Code. Because of our approach to this problem, we avoid the need to consider maintaining a distinction in result based on minor variations in tax planning to similar ends.[5]

The substance of a transaction rather than its form must ultimately determine the tax liabilities of individuals. *Gregory v. Helvering*, 293 U.S. 465, 470 (1935); *Commissioner of Internal Revenue v. Court Holding Co.*, 324 U.S. 331, 334 (1945); *Foresun, Inc. v. Commissioner of Internal Revenue*, 348 F.2d 1006, 1008 (6th Cir. 1965). When one overall transaction transferring property is carried out through a series of closely related steps, courts have looked to the essential nature of the transaction rather than to each separate step to determine tax consequences of the transfer. *Commissioner of Internal Revenue v. Ashland Oil & Refining Co.*, 99 F.2d 588 (6th Cir.), *cert. denied*, 306 U.S. 661 (1939); *Kimbell-Diamond Milling Co. v. Commissioner of Internal Revenue*, 14 T.C. 74 (1950), *aff'd per curiam*, 187 F.2d 718 (5th Cir.), *cert. denied*, 342 U.S. 827 (1951); *American Potash & Chemical Corp.*

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5. Minor variations in form may mean dramatically different results in proper cases. The "substance over form" argument is not a magic incantation which makes a transaction tax-exempt at a taxpayer's command (or taxable at the Commissioner's wish). For example, suppose the taxpayers here had chosen to sell their stock to the trust for $500,000, and had then given the trust $500,000, on the condition that the trust give them $50,000 and pay their gift taxes. Aside from tax events the identical result would be reached between donors and donees. Yet, it would be a startling contention that the initial sale should escape taxation — and in a greater amount than imposed through Appellants' transactions. *See Edmister v. Commissioner of Internal Revenue*, 391 F.2d 584 (6th Cir. 1968); *Montesi v. Commissioner of Internal Revenue*, 340 F.2d 97 (6th Cir. 1965).

v. United States, 399 F.2d 194 (Ct. Cl.), *pet. for rehearing*, 402 F.2d 1000 (Ct. Cl. 1968). The substance of the transactions in this case was a gift of $500,000 worth of stock in exchange for $200,000, $150,000 of which was used to pay the donor's gift taxes.[6]

Whether we describe this substance as a "part sale and part gift" or a "net gift" has no importance. The fact is that each taxpayer received something of value upon transferring his encumbered stock into trust. Dr. Johnson received $200,000, free and clear of any obligation to repay that amount from any property in his possession. This amount constituted gross income in the year of receipt, under the broad definition set forth in section 61 of the Code—"all income from whatever source derived." It makes no difference to what use the $200,000 was put, whether to pay for food or to pay a gift tax.

The same result would be reached if we describe the $150,000 used to pay the gift taxes on the transfer into

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6. Taxpayers point out that the original assessment of Tennessee and federal gift taxes was $208,497.51, which exceeds the loan taken out by Dr. Johnson. They argue that this undermines the Tax Court's point that the $50,000 received over and above the eventual gift tax assessment indicates that taxpayers were "in reality" making a "part sale" of their stock rather than a "net gift." This entire semantic discussion is irrelevant under our analysis of the case.

Were we to adopt the Tax Court's reasoning that a "part sale, part gift" was involved in this case, we would be hard put to justify the Tax Court's "finding" to that end. In *Turner* the Tax Court held that in cases where donees are obligated to pay gift taxes, courts have "looked at the facts of each case, including the close family relationship involved, and have determined what was in fact intended by the parties." 49 T.C. at 362. It is difficult to find that the parties here actually intended a part sale, part gift, in view of the obvious tax implications of such an intention. It is better to apply the Tax Code equitably to basically similar transactions than to impose different results depending upon a hindsight determination of "actual intent."

trust as equivalent to what happened in *Turner* (donees' assumption of donor's gift tax liability). If we view the $150,000 receipt as the payment of the donor's gift tax by the donee, then the donor has nonetheless realized income. The gift tax liability is the *donor's* legal obligation under section 2502(d) of the Code,[7] and "[t]he discharge by a third person of an obligation to him is equivalent to receipt by the person taxed." *Old Colony Trust Co. v. Commissioner of Internal Revenue*, 279 U.S. 716, 729 (1929) (taxing as income employer's payment of employee's income taxes). *Accord, Safe Harbor Water Power Corp. v. United States*, 303 F.2d 928 (Ct. Cl. 1962) (payment of income taxes); *Schaeffer v. Commissioner of Internal Revenue*, 258 F.2d 861, 864 (6th Cir. 1958) (net increase in accrual basis taxpayer's reserve account with purchaser); *Guarantee Title & Trust Co. v. Commissioner of Internal Revenue*, 313 F.2d 225, 228 (6th Cir. 1963); *Malone v. United States*, 326 F.Supp. 106, 112 (N.D. Miss. 1971), *aff'd* 455 F.2d 502 (5th Cir. 1972) (payment of mortgage). The payment of a donor's gift tax liability by the donee constitutes income to the donor.

We note that the identical conclusion would be mandated if we focus upon Dr. Johnson's shedding of the $200,000 debt by transferring the encumbered stock into the trust. Under *Crane v. Commissioner of Internal Revenue*, 331 U.S. 1 (1947), the taxpayer realized income in the amount of the debt disposed of, regardless of the

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7. The donee may eventually become liable for the gift tax if the donor fails to pay when the tax is due and the Internal Revenue Service chooses to hold the donee rather than the donor. Section 6324(b). Donee liability is, however, in the nature of a lien rather than an alternative source of personal liability at the taxpayers' option, at least before the tax is actually due and payable. *See Estate of Scheaffer v. Commissioner of Internal Revenue*, 313 F.2d 738, 741 (8th Cir. 1963).

fact that he was not personally liable on the debt.[8] We believe that the transactions in this case fall within the parameters of *Crane*, especially in view of the fact that the taxpayers actually received cash without liability to repay the notes out of their own assets. *See First National Industries, Inc. v. Commissioner of Internal Revenue*, 404 F.2d 1182 (6th Cir. 1968), *cert. denied*, 394 U.S. 1014 (1969) (donor charged with capital gain upon the gift of property subject to a mortgage); *Simon v. Commissioner of Internal Revenue*, 285 F.2d 422 (3d Cir. 1960); *O'Dell & Sons Co., Inc. v. Commissioner of Internal Revenue*, 169 F.2d 247 (3d Cir. 1948).

Taxpayers, on the other hand, cite no Code provision which exempts their receipt of $200,000 from taxation at the time of the transfers into trust. No "roll-over" provision exists to allow taxpayers to shift highly appreciated stock into a trust without incurring a capital gains tax on the amount realized by the donor through the donees' payment of the gift taxes. Congress has stringently limited the transactions which merit "roll-over" treatment (allowing a transfer of property without triggering a taxable event). See sections 1031-1038, Int. Rev. Code of 1954. The transactions engaged in here are not among those exempted from tax.[9]

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8. There has been some question of whether the Supreme Court intended in *Crane* to establish the unwavering principle that the shedding of debt *per force* gives rise to taxable income. *See* Adams, "Exploring the Outer Boundaries of the Crane Doctrine; An Imaginary Supreme Court Opinion," 21 Tax L. Rev. 159 (1966); *Parker v. Delaney*, 186 F.2d 455, 459 (1st Cir. 1950) (Magruder, J., concurring), *cert. denied*, 341 U.S. 926 (1951).

9. The roll-over provisions present in *Woodsam Associates, Inc. v. Commissioner of Internal Revenue*, 198 F.2d 357 (2d Cir. 1952), took one transaction therein outside the *Crane* doctrine. While a gift is specifically excluded from a donee's taxable income, there is no authority that makes a gift transfer a nontaxable event as to the donor.

Thus, we find no basis whatsoever in the provisions of the Code for taxpayers' assertion that a donee's discharge of a donor's gift tax liability does not constitute the realization of income if a donor's tax attorneys structure the transactions in a certain manner. The donor must somehow obtain the cash necessary to pay his gift taxes. If he acquired the cash upon the transfer of the donated property, then he realized income, so long as the amount received exceeds his basis in the donated property. Section 1001(b). This is true whether we view the event triggering the realization of income as a sale or as the discharge of indebtedness or as something else. If, as the Tax Court held, the $200,000 in cash was received through a "sale" of the stock (the entire transaction constituting in part a sale and in part a gift), then the stock's disposition is included in gross income under section 61(a)'s general definition of income as well as the specific language of clause (3) ("gains derived from dealings in property"), the amount realized under section 1001(b) is $200,000 ("the sum of any money received [$200,000] plus the fair market value of the property (other than money) received [$0]") minus $10,000 basis, and the tax would be imposed at capital gains rates under section 1201(b) ("gain from the sale . . . of a capital asset held for more than 6 months" within section 1222(3)). If we view the transaction herein as a discharge of gift tax indebtedness occasioned by the donees' payment of the gift tax, as taxpayers contend, the $50,000 received in excess of gift taxes paid is taxable at capital gain rates (conceded by taxpayers and specifically taxable under section 61(a)(12) as "income from discharge of indebtedness," *inter alia*), the $150,000 which was received by the donor and used to pay his gift taxes is taxable under *Old Colony Trust*, as well as *Crane*, the amount realized is [$50,000 plus $150,000] minus [$10,000 basis] = $190,000 under § 1001

(b), ("gain from the . . . other disposition of property"), and the tax is imposed at capital gains rates under § 1201 (b) (gain from the . . . exchange of a capital asset held for more than six months"). We find it immaterial whether the transaction is found to be "part sale and part gift."[10] This suggestive but artificial language should not obscure the essence of the transaction in which the taxpayers engaged—the transfer of highly appreciated stock to a trust for their children's benefit, with the funds to pay their gift taxes raised out of the transferred property, plus additional cash. The effect of imposing a capital gains tax at the time of the stock's transfer is to collect the tax at that time, rather than to defer the tax until the trustees dispose of it through a taxable event. Since money can easily be obtained to pay the capital gains tax at the time of the transfer, we see no policy objection to imposing the tax at that time.[11]

In view of our holding, we are obligated to comment specifically on the major case on which Appellants rely—*Turner v. Commissioner of Internal Revenue*, 410 F.2d 752 (6th Cir. 1969), *aff'g* 49 T.C. 356 (1968). Taxpayers cite *Turner* for the proposition that a donor realizes no income when he makes a "net gift" and requires the donee to pay his gift taxes. The source of this asserted principle lies in a maze of cases wherein the Commissioner

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10. This language may be significant for determining the basis of donated property under the Income Tax Regulations, § 1.1015-4. But as discussed below, text at n.12, the basis problem is easily solved without recourse to magic labels.

11. Indeed, in this case, the "extra" $50,000 retained by each taxpayer over and above his gift taxes is approximately the amount of capital gains tax assessed. The donor who chooses to require the donees to pay his gift tax could simply require the donee to pay his recognized capital gain tax as well, though this might lead to further difficulties. *See Old Colony Trust Co. v. Commissioner of Internal Revenue*, 279 U.S. 716 (1929); *Safe Harbor Water Power Corp. v. United States*, 303 F.2d 928 (Ct. Cl. 1962).

tested out § 677(a) of the Code, which imposes a tax *at ordinary income rates* upon amounts retained or received by a grantor upon transfer of property into trusts. *See Estate of Staley*, 47 B.T.A. 260 (1942), *aff'd* 136 F.2d 368 (5th Cir.), *cert. denied*, 320 U.S. 786 (1943); *Estate of Sheaffer*, 37 T.C. 99 (1961), *aff'd*, 313 F.2d 738 (8th Cir.), *cert. denied*, 375 U.S. 818 (1963); *Estate of Morgan*, 37 T.C. 981 (1962), *aff'd per curiam*, 316 F.2d 238 (6th Cir.), *cert. denied*, 375 U.S. 825 (1963); *Estate of Sheaffer*, 25 T.C. Mem. 646 (1966); *Richard M. Turner*, 49 T.C. 356 (1968), *aff'd per curiam*, 410 F.2d 752 (6th Cir. 1969); *Victor W. Krause*, 56 T.C. 1242 (1971), *appeal dismissed*, (*nolle pros*), (6th Cir. June 27, 1972); *Estate of Davis*, 30 T.C. Mem. 1363 (1971), *aff'd per curiam*, 469 F.2d 694 (5th Cir. 1972). In none of these cases, however, did the Commissioner strongly argue, nor did the courts carefully consider, what the Commissioner argues here—that aside from section 677 certain amounts should be taxed. In fact, in *Turner* the Commissioner "conceded that the amounts paid by the trustee to the doner (*sic*) were not taxable to her. . . ." 410 F.2d at 753.

In addition, the Tax Court was concerned that the Commissioner's "part sale and part gift" contention would lead to a doubling of credit for the gift tax paid in the donees' basis, under Section 1.1015-4, Income Tax Regs. 49 T.C. at 363-64. This concern was without justification, as analysis of the facts in this case demonstrates. Under that regulation, assuming it is relevant (rather than § 1.1015-2),[12] the donee's basis would be $200,000 (the

12. Since the gifts in this case were "transfers in trust," § 1.1015-2 would seem applicable. Section 1.1015-4 was designed to deal with problems peculiar to "part sale and part gift" situations in the nature of true "bargain sales." Section 1015 itself was a response to the bargain sale problem. *See Farid-es-Sultaneh v. Commissioner of Internal Revenue*, 160 F.2d 812 (2d Cir. 1947).

"amount paid by the transferee for the property") plus $150,000 (gift tax paid), but limited to the fair market value of the gift (approximately $300,000 here). There is actually no "double credit" involved. The $150,000 received by the donor which was used to pay his gift tax is included as an increase to the donee's basis because the donor will have paid a capital gain on that amount of appreciation of his stock and that portion of the stock's increase in value should not again be taxed. The $150,000 increase in the donee's basis which is attributable to gift taxes paid by the donor is independently proper. Its function, separate from that of the other $150,000 increase, is not to discourage gifts. Were basis not raised by the amount of gift taxes paid, a donor would recognize that a shift of resources to the donees would incur a tax without a corresponding adjustment in basis for the donees. Thus, Congress has authorized increases in a donee's basis both by amounts of gain recognized upon transfers to trust and by amounts of gift taxes paid, regardless of the fact that such amounts may superficially appear redundant.[13] *See* section 1015(b), (d); § 1.1015-2, -4, -5, Income Tax Regs.

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13. The provision allowing an increase of the donee's basis in donated property by the amount of gift taxes paid was added in 1958. The Senate Report recommending the change stated that the absence of such a provision ignored a "cost" of making a gift—the cost of the gift tax. "As a result, [the] committee has concluded that to properly reflect total 'costs' incurred with respect to donated property, it is necessary to increase the basis of the property by the amount of any gift tax paid with respect to it. . . . However, the basis of the property as a result of this addition of the gift tax to the basis is not to be increased to more than the fair market value of the property at the time of the gift. A limitation of this type means that cash will be treated no less favorably than other property, and that there will be no incentive to convert cash into securities in order to obtain an increase in basis above the fair market value of the property." Sen. Rept. No. 1983, 85th Cong., 2d Sess., U.S. Code Cong. & Adm. News, 4859-60 (1958).

Thus, the *Turner* case does not support the taxpayers' position. *Turner* has no precedential value beyond its peculiar fact situation, in view of the Commissioner's concessions in that case both in the Tax Court and on appeal to this Court.

We conclude that the deficiencies assessed by the Commissioner must be allowed, for the reasons stated in this opinion. On this basis, the decision of the Tax Court is affirmed.

JUDGMENT ENTRY OF THE COURT OF APPEALS IN NO. 73-1908

(Filed April 9, 1974)

No. 73-1908

UNITED STATES COURT OF APPEALS
FOR THE SIXTH CIRCUIT

JOSEPH W. JOHNSON, Jr., and MARGARET A. JOHNSON,
Petitioners-Appellants,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent-Appellee.

Before: CELEBREZZE, PECK and ENGEL, *Circuit Judges.*

On appeal from a decision of the Tax Court of the United States.

This cause came on to be heard on the transcript of record from the Tax Court of the United States and was argued by counsel.

ON CONSIDERATION WHEREOF, It is now here ordered and adjudged by this court that the decision of the said Tax Court in this cause be and the same is hereby affirmed.

It is further ordered that Respondent-Appellee recover from Petitioners-Appellants, the costs on appeal, as itemized below, and that execution therefor issue out of said Tax Court.

ENTERED BY ORDER OF THE COURT

/s/ JOHN P. HEHMAN
Clerk

JUDGMENT ENTRY OF THE COURT OF APPEALS IN NO. 73-1909

(Filed April 9, 1974)

No. 73-1909

UNITED STATES COURT OF APPEALS
FOR THE SIXTH CIRCUIT

H. CLAY EVANS JOHNSON, AND BETTY MEAD JOHNSON,
Petitioners-Appellants,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent-Appellee.

Before: CELEBREZZE, PECK and ENGEL, *Circuit Judges.*

On Appeal from a decision of the Tax Court of the United States.

This cause came on to be heard on the transcript of record from the Tax Court of the United States, and was argued by counsel.

ON CONSIDERATION WHEREOF, It is now here ordered and adjudged by this court that the decision of the said Tax Court in this cause be and the same is hereby affirmed.

It is further ordered that Respondent-Appellee recover from Petitioners-Appellants, the costs on appeal, as itemized below, and that execution therefor issue out of said Tax Court.

ENTERED BY ORDER OF THE COURT

/s/ JOHN P. HEHMAN
Clerk

JUDGMENT ENTRY OF THE COURT OF APPEALS IN NO. 73-1910

(Filed April 9, 1974)

No. 73-1910

UNITED STATES COURT OF APPEALS
FOR THE SIXTH CIRCUIT

DAVID F. S. JOHNSON, AND ELISE E. JOHNSON,
Petitioners-Appellants,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent-Appellee.

Before: CELEBREZZE, PECK and ENGEL, *Circuit Judges.*

On appeal from a decision of the Tax Court of the United States.

This cause came on to be heard on the transcript of record from the Tax Court of the United States, and was argued by counsel.

ON CONSIDERATION WHEREOF, It is now here ordered and adjudged by this court that the decision of the said Tax Court in this cause be and the same is hereby affirmed.

It is further ordered that Respondent-Appellee recover from Petitioners-Appellants, the costs on appeal, as itemized below, and that execution therefor issue out of said Tax Court.

ENTERED BY ORDER OF THE COURT

/s/ JOHN P. HEHMAN
Clerk

ORDER OF THE COURT OF APPEALS DENYING PETITION FOR REHEARING

(Filed May 30, 1974)

Nos. 73-1908-10

UNITED STATES COURT OF APPEALS
FOR THE SIXTH CIRCUIT

JOSEPH W. JOHNSON, JR, and Wife, MARGARET A. JOHNSON; and H. CLAY EVANS JOHNSON and Wife, BETTY MEAD JOHNSON; and DAVID F. S. JOHNSON and Wife, ELISE E. JOHNSON,

Petitioners-Appellants

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent-Appellee.

ORDER

Before: CELEBREZZE, PECK and ENGEL, *Circuit Judges.*

Appellants' petition for rehearing having come on to be heard, and no judge of this Court having requested a vote on the suggestion that it be considered en banc,

IT IS ORDERED that the petition be, and it is, hereby denied.

Entered by order of the Court.

/s/ JOHN P. HEHMAN
Clerk